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STICKY DEFAULTS AND ALTERING RULES IN CORPORATE LAW

*Brett H. McDonnell**

CORPORATE law scholarship has long debated the extent to which corporate law rules are default or mandatory. It has paid less attention to corporate law's "altering rules," which prescribe what a corporation must do to legally opt out of a given default rule. Altering rules may be more or less sticky; that is, they may make it easier or harder to opt out of a given default rule. They also help allocate authority among corporate constituency groups. A descriptive focus on altering rules provides a more detailed and nuanced understanding of the contours of corporate law than the simple default/mandatory dichotomy. A normative focus on altering rules demonstrates that, in many cases, it may be desirable to make it moderately hard to opt out of some default rules. These descriptive and normative perspectives provide more regulatory guidance and shareholder protection than a Teflon altering rule, but still leave the law more flexible than with mandatory rules. After introducing a variety of useful distinctions and considering the main policy factors that argue for more or less sticky altering rules, this paper applies the altering rule concept to a variety of corporate law issues: bylaws versus charters, supermajority rules, sunset provisions, the duty of loyalty, the doctrine of independent significance, reincorporation, close corporation rules, public corporation rules, and the choice between corporate law and other sorts of business association law. The altering rule concept thus provides a unifying perspective on many parts of the law. It also suggests a more complicated and nuanced picture than a simplistic version of corporate law contractarianism. If corporations are persistent enough, they can indeed opt out of most of the rules that corporate law sets for them, though the law generally does not make opting out very easy. Corporate law thereby plays a much stronger guiding role than the simple contractarian picture would suggest.

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I. INTRODUCTION

Over the last several decades, law and economics has come to dominate corporate law scholarship. As this process began in the seventies and eighties, one of the great debates concerned the extent to which corporate law does and should consist of default rules as opposed to mandatory rules. To the uninitiated, that might not seem like such a great debate. However, it implicates fundamental questions of how well markets work and how forcefully we should use the law to regulate corporations. The idea that most of corporate law is and should be governed by default rules is a central tenet of the contractarian approach which now dominates the field.¹

A default rule is one that applies only in the absence of an agreement by the relevant parties to be governed by a different rule. According to the contractarian vision, corporate law provides a series of convenient, off-the-rack default rules that most corporations will find useful to follow most of the time. By adopting the law of a state with a good set of rules, a corporation need not re-invent the wheel at much expense. However, if the parties who have formed a particular corporation find that some of the default rules in their state do not work well for them, they should be able to choose to be governed by a different rule. If markets work well and there are few significant externalities, then the parties involved will be in the best position to choose the rules that should govern them. A law filled with default rules allows them to do just that.²

As the economic approach established its dominance within corporate law scholarship, those opposed to the contractarian position argued over both the extent to which corporate law actually consists of default rules, and even more over the extent to which it should consist of default rules.³ As a descriptive matter, the labeling of most corporate law rules as default rules has widely prevailed, with the possible important exception of at least some elements of fiduciary duty law.⁴ As a normative matter the debate continues, but approval of the default rule approach is clearly the dominant position within contemporary scholarship.⁵

Despite the longstanding debate over default versus mandatory rules, scholars have paid much less attention to how easy it is to opt out of the default rules—that is, how “sticky” the rules are. A variety of factors affect how sticky any given rule is. Of central concern to this paper is that the law itself helps determine the stickiness of its default rules. A series of legal rules defines what conditions the parties in a corporation must

1. See generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Henry Hansmann & Reinier Kraakman, *The End of History in Corporate Law*, 89 GEO. L.J. 439, 444–49 (2001).

2. See EASTERBROOK & FISCHEL, *supra* note 1, at 2–22; *infra* notes 6–12 and accompanying text.

3. See Lucian Bebchuk, Foreword, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1408–15 (1989).

4. *Id.*

5. *Id.*

comply with in order to successfully opt out of a given default rule in a way that is legally recognized. I call these rules *altering rules*.⁶ They define what a corporation must do to alter the default rules that may apply.

Altering rules can be more or less sticky, meaning they can make it more or less hard to opt out of the prevailing default rules. Altering rules can be arrayed on a spectrum from not at all sticky (Teflon rules) to quite sticky. Indeed, one can think of mandatory rules as simply the latter extreme of this spectrum; that is, defaults with extremely sticky altering rules. The core idea of this paper is that one should pay much more systematic attention to the stickiness of corporate law's altering rules, not just to the simple default/mandatory dichotomy.

What might we gain from doing so? We can gain in both descriptive and normative accounts of corporate law. Descriptively, we can get a much more nuanced understanding of the law. Rather than the binary choice of labeling a rule as default or mandatory, we can place various rules along a spectrum of stickiness. As we shall see, in many cases, figuring out exactly what the altering rules in a particular area of the law are and how they operate to make opting out of the default rule more or less hard is quite a tricky and subtle inquiry. We will come to understand the law in much richer detail if we focus on this question. That question examines not only how hard it is to opt out of the default rule, but also to whom the authority to opt out is given. Thus, the answer to this question crucially affects the assignment of authority within the corporation. Moreover, as we shall see in Part IV below, the altering rule concept allows us to tie together quite a disparate set of topics. In that part, I discuss bylaws versus charters,⁷ supermajority rules, sunset provisions, the duty of loyalty, the doctrine of independent significance, reincorporation, close corporation rules, public corporation rules, and the basic choice between corporate law and other sorts of business association law, all as instances of the operation of altering rules.

The gains from focusing on altering rules are at least as great for our normative accounts of corporate law. The debate over default rules to date has largely focused on a relatively blunt choice: a rule can be either default or mandatory. A broader choice is probably more desirable. After all, in many cases both the arguments for and against default rules have a good deal of merit. Frequently, we might find ourselves wishing to have some of the protective and guiding power of mandatory rules without the inflexibility that they entail. Markets often do not work as well as the strong contractarian vision suggests. We might therefore want to do more to shape and limit the market than that vision counsels. On the other hand, markets usually work fairly well, so we should not want to

6. Ian Ayres coined the term. See Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3, 6 (2006).

7. Some states, including Delaware, refer to the charter as the "certificate of incorporation," and others as the "articles." I shall generally use the term "charter" to refer to both, although at times I will use the term "certificate" when referring to Delaware's law in particular.

completely constrain them either. In addition, government-chosen rules also are subject to error. We might want to choose a middle way between Teflon defaults and mandatory rules. The existence of a range of altering rules gives us that choice. Choosing an altering rule with an intermediate degree of stickiness permits a compromise in the choice between Teflon defaults or inflexible mandatory rules. We might often find that such an intermediate position presents a better trade off than either of the extremes. Moreover, altering rules affect who has the power to opt out of default rules, providing a wider range of conceptual tools for deciding how best to allocate authority within a corporation.

The picture that emerges presents a serious challenge to a simple, stark version of corporate law as purely contractarian. After a literature review in Part II, Part III argues that altering rules of intermediate stickiness are often desirable for a variety of reasons. Somewhat sticky rules may help protect shareholders, create desirable legal uniformity, and protect other corporate constituencies. The law allows corporations to circumvent these protections because doing so may sometimes make sense, or because lawmakers are not confident that such legal defaults are always optimal. Nevertheless, by making circumvention rather costly, we are able to gain some of the advantages that favor mandatory rules, while reducing the costs of such rules.

Part IV surveys a wide range of corporate law altering rules. Many of those rules are indeed Teflon rules—a simple majority of the board may quickly and easily opt out of the rule. However, many other altering rules are much stickier. The simplistic default/mandatory distinction paints a corporate law picture with too coarse of a stroke. The altering rule provides corporate law with more subtle and interesting aesthetics. If corporations are persistent enough, they can indeed opt out of most of the rules that corporate law sets for them, though the law does not generally make opting out very easy. Corporate law thereby plays a much stronger guiding role than the simple contractarian picture would suggest.

II. PAST DISCUSSIONS

This article's analysis of altering rules touches on several major ongoing discussions that have played a big role in corporate law scholarship over the last several decades. These discussions include the debate over mandatory versus default rules, how default rules should be set, an emerging literature drawing upon behavioral law and economics, and discussions of the various specific sorts of rules laid out in Part IV.

Underlying all of these discussions is the contractarian approach to corporate law, which began to take hold in law reviews in the 1970s and became dominant by the early 1990s. This approach was the result of early efforts to apply economic theory to corporate law. The economic theory that scholars drew upon ultimately went back to Ronald Coase's

vital paper titled *The Nature of the Firm*,⁸ but the work of Michael Jensen and William Meckling was perhaps even more influential.⁹ Jensen and Meckling described the firm as a nexus of contracts.¹⁰ That is, a corporation is really just a convenient legal fiction.¹¹ Behind that fiction is a complex set of interrelated voluntary contractual relationships between different groups, such as shareholders, managers, employers, creditors, suppliers, customers, and the like.¹²

Economists tend to believe that private parties generally do a good job of protecting their interests when they enter into voluntary arrangements, and thus there is little need for extensive governmental regulation to protect them, so long as those arrangements do not have major effects on third parties. This pro-market bias was particularly marked in the work of many of the economists such as Coase and Jensen, who significantly influenced early law and economics corporate scholars. Thus, one of the great questions in the original¹³ application of economics to corporate law was what legitimate role, if any, the law had to play in regulating corporate transactions.

The core answer to that question was that corporate law provides a convenient set of off-the-rack rules that help solve problems that arise for many business associations.¹⁴ Choosing to use those rules allows each individual corporation to avoid having to re-invent the wheel. However, not every rule will work well in the specific circumstances of each corporation. Moreover, those setting the basic rules may not always choose wisely in how they set the rules. For both of these reasons, contractarians advocate allowing corporations to opt out of the rules that would otherwise apply to them in circumstances where those involved in the corporation do not believe the standard answer is best for them. That is to say, (or so the contractarians say), the rules of corporate law should be default rather than mandatory.¹⁵ This answer emerged particularly clearly in the work of Easterbrook and Fischel,¹⁶ and also pervades the work of schol-

8. Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

9. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 *J. FIN. ECON.* 305, 314 (1976). Work by Oliver Williamson and by Oliver Hart and his collaborators was also quite influential. See generally OLIVER HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* (Clarendon Press 1995); OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985); OLIVER E. WILLIAMSON, *THE MECHANISMS OF GOVERNANCE* (1996); Sanford Grossman & Oliver Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 *J. POL. ECON.* 691 (1986); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 *J. POL. ECON.* 1119 (1990).

10. Jensen & Meckling, *supra* note 9, at 314–15.

11. *Id.*

12. *Id.*

13. “Original” at least for the modern law and economics movement. This statement does not hold true for earlier generations of economists who influenced legal thinking about corporations, such as Commons and Means. See generally ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); JOHN R. COMMONS, *THE LEGAL FOUNDATIONS OF CAPITALISM* (1923).

14. See EASTERBROOK & FISCHEL, *supra* note 1, at 6–15.

15. *Id.*

16. *Id.*

ars such as Romano and Winter, who helped create the basic conceptual framework of modern corporate law scholarship.¹⁷

Not everyone fully agreed (or agrees) with this answer either as a description of what corporate law actually does or as a prescription for what it should do. Some argued that important parts of corporate law, particularly the central topic of fiduciary duties, did and should constitute mandatory rules that preclude corporations from opting out. This became one of the key battles of modern corporate law scholarship, culminating in the famous 1989 Columbia Law Review Symposium in which many of the key combatants on both sides laid out the essence of their cases.¹⁸

On the descriptive side, some such as Eisenberg,¹⁹ Coffee,²⁰ and Gordon²¹ argued that critical elements of corporate law are mandatory. Contractarians riposted that even where a rule on its face appears mandatory, there are ways to get around the rule.²² For instance, consider the exchange between Gordon and Romano.²³ Gordon points to a variety of provisions in the Delaware Code which he describes as mandatory, including annual election of directors by shareholders, board terms limited to no more than three years, the demand requirement for derivative suits, the appraisal remedy for certain mergers, and the duty of loyalty backed by the possibility of a derivative suit.²⁴

Romano replies that all of these rules can be sidestepped, or are trivial because no one has any desire to sidestep them.²⁵ Directors may run for an unlimited number of terms and boards may control the nominating process.²⁶ The demand requirement may be dismissed as futile.²⁷ An acquisition can be structured so as to avoid the appraisal remedy.²⁸ A charter may eliminate liability for violations of the duty of care, and disinterested directors can approve self-dealing transactions.²⁹ A corporation may re-incorporate if it does not like the rules of a state.³⁰ Note

17. See generally ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993); William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1482-1526 (1989) (providing the historical overview); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

18. See Bebchuk, *supra* note 3, at 1395-99.

19. Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1462 (1989).

20. John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1619-20 (1989).

21. Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1554 (1989).

22. Coffee, *supra* note 20, at 1618-19.

23. See Gordon, *supra* note 21, at 1553 n.16.

24. *Id.*

25. See Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Law*, 89 COLUM. L. REV. 1599, 1599-1601 (1989).

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

that this reply does not really examine how easy it is to get around these rules, although Romano asserts that the rules are “easily- and legally-side stepped.”³¹ The fact that one can get around the rule makes it default rather than mandatory, and so the contractarian position has been defended.³² The argument does not question whether the ease of opting out of the rule might matter for an analysis of how the rule is likely to work.

Pushing the contractarian argument even further, the triviality hypothesis maintains, in a sense, that virtually all of state corporate law is trivial, because corporate managers and investors are able to implement whatever governance rules they want.³³ Bernard Black argues that most state law rules are trivial for at least one of four reasons: they are market-mimicking, in that virtually all corporations would adopt them anyway, they are avoidable through advance planning, they are politically changeable, or they are unimportant.³⁴ The avoidability claim is particularly closely related to our discussion of altering rules. Indeed, in the course of discussing avoidability, Black points to the importance of what he calls “change governing” rules, which “govern changes to the initially established terms.”³⁵ This is essentially the concept of altering rules.

On the prescriptive side, the contractarians elaborated on the basic argument for default rules laid out above.³⁶ The anti-contractarians laid out a variety of objections, often themselves drawing on economic arguments.³⁷ Three main sorts of arguments for mandatory rules predominated. First, mandatory rules could protect shareholders from bad arrangements that they might agree to due to problems in information, bad judgment, or obstacles to effective collective action.³⁸ Second, mandatory rules might help achieve valuable uniformity across firms.³⁹ Finally, mandatory rules might protect third parties, such as creditors or consumers.⁴⁰ Even contractarians agree with these arguments as logical possibilities.⁴¹ Thus, the disagreements were often over the relative empirical strength of the arguments for and against mandatory rules.⁴²

There has also been some discussion in the literature of how default rules should be chosen. The starting point for this literature is a 1989 article by Ayres and Gertner, which covers much more than just corpo-

31. *Id.* at 1599.

32. *Id.*

33. See Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 Nw. U. L. Rev. 542, 544 (1990).

34. See *id.*

35. *Id.* at 557.

36. See, e.g., Gordon, *supra* note 21, at 1556–64.

37. *Id.* at 1556.

38. *Id.* at 1556–62.

39. See *id.* at 1567–69.

40. *Id.*

41. See EASTERBROOK & FISCHEL, *supra* note 1, at 23–34.

42. For instance, even Easterbrook and Fischel accept as valuable an occasional mandatory rule. See *supra* note 1, at 25–34.

rate law.⁴³ Before Ayres and Gertner, the standard approach to thinking about how rulemakers should set default rules was what I shall call the majoritarian approach. Majoritarian theorists apply the rule that a majority of relevant corporations would choose as the default rules if they were to address the matter. Ayres and Gertner began a tradition of what some call minoritarian rules, which choose on a different basis.⁴⁴ They described what are called penalty defaults, which set a default option that is objectionable to one or more of the parties as an incentive for that party to opt out of the rule and thereby reveal information either to other parties or to state rulemakers.⁴⁵

There are other possible types of minoritarian rules. One may set a rule favoring one type of party as a way of protecting that party from possible exploitation. Alternatively, one may set the default one way because it is easier and less costly to opt out of that default than the opposite default, and hence corporations are less likely to get stuck in an inefficient position.⁴⁶ An interesting extended use of this idea comes from Bebchuk and Hamdani.⁴⁷ They argue that, where a rule can be categorized as either pro-shareholder or pro-management, other things being equal, we should set the pro-shareholder option as the default rule.⁴⁸ In most instances corporations will be more likely to opt out of inefficient pro-management rules than inefficient pro-shareholder rules.⁴⁹ That is because management has the power of initiating (or refusing to initiate) an opt out in the case of rules where opting out occurs through amending the charter.⁵⁰ Even where opting out can occur in the bylaws, and hence either management or shareholders may initiate, shareholders will typically find it harder to initiate an opt out due to the high costs of collective action.⁵¹

Some of the burgeoning behavioral law and economics literature has considered the stickiness of default rules. The basic argument is that due to a variety of behavioral biases in decisionmaking, people will tend not to opt out of a prevailing default rule, even though the rule may be inefficient.⁵² The default rule affects the preferences of parties.⁵³ "When lawmakers anoint a . . . term the default, the substantive preferences of contracting parties shift—that term becomes more desirable, and other

43. See generally Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

44. See generally Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 STAN. L. REV. 1591 (1999).

45. *Id.* at 1591–92.

46. See Robert Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1, 18–19 (1982) (applying normative Coase theorem).

47. Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 491 (2002).

48. *Id.*

49. *Id.* at 492.

50. *Id.*

51. *Id.* at 506.

52. See Black, *supra* note 33, at 625.

53. *Id.*

competing terms becom[e] less desirable.”⁵⁴ This is closely related to the endowment effect, whereby parties value a right or good more highly if it is initially allocated to them.⁵⁵

Not everyone believes in the endowment effect in general. Plott and Zeiler argue that the effect that a variety of researchers have observed is due to the mechanics of how they have conducted experiments, rather than to the posited psychological mechanisms.⁵⁶ Arlen argued that the endowment effect is less likely to be present in the types of transactions that corporate law covers, which often involve sophisticated financial market participants, or at least where the possibility of arbitrage is likely to drive out inefficient choices.⁵⁷

However, some interesting evidence for the stickiness of default rules in corporate law and for the related phenomenon of menu effects comes from recent work by Yair Listokin.⁵⁸ Listokin considered variations among state anti-takeover statutes, some of which require corporations to opt in and others to opt out.⁵⁹ He found large differences in the two types of states—corporations rarely opt out of antitakeover statutes, but states with opt in statutes see a mix.⁶⁰

Moreover, the endowment effect or status quo bias may be stronger when we consider elements of corporate law or related areas that fall outside the main focus of most corporate law scholars. Most American corporate law scholars focus mainly on the relationships between the board, shareholders, and officers in large public corporations with dispersed shareholdings and active secondary markets for those shares. Many shareholders are sophisticated institutions or individuals. The directors are typically high-powered individuals with powerful outside jobs. The officers typically are also among society’s elite and powerful, with plenty of outside options. These are groups and contexts likely to elicit behavior that is closer to the unemotional rationality of homo economicus than almost any other social role.

If instead one focuses on closely held corporations, things might look different. Such corporations are typically run by their founders or by the

54. Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 611 (1998).

55. See *id.* at 625. For instance, in one classic experiment, half of the subjects are assigned mugs, and then allowed to trade with those who do not have mugs. Those who receive the mugs value them at twice the value than those who do not receive them, despite having had the mugs for only minutes. See Christine Jolls et. al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1484 (1998).

56. See Charles R. Plott & Kathryn Zeiler, *The Willingness to Pay—Willingness to Accept Gap, the “Endowment Effect,” Subject Misconceptions, and Experimental Procedures for Eliciting Valuations*, 95 AMER. ECON. REV. 530 (2005).

57. Jennifer Arlen et. al., *Endowment Effects Within Corporate Agency Relationships*, 31 J. LEGAL STUD. 1, 18–21 (2002).

58. See Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination* 34–42 (Yale Law & Econ. Research Paper No. 335), available at <http://ssrn.com/abstract=92457e>.

59. *Id.* at 29.

60. *Id.*

families of the founders, people with an intense personal stake in the business. They usually do not tap into sophisticated financial markets. Emotions may become even more important within more unique businesses, such as cooperatives, run according to the Rochdale principles.⁶¹ Here, the members may be strongly committed to their sense of the fair background rules. Even in large public corporations, if we expand our notions of corporate governance to include relations with employees,⁶² then the status quo bias plausibly would seem to be potentially important.⁶³

A related recent development out of behavioral law and economics has been the concept of libertarian paternalism. The idea is that we can use the law to try and protect individuals or groups seen as at risk in various ways, though not through mandatory rules, but rather through manipulation of other sorts of rules, such as providing information or setting default rules in an appropriate way.⁶⁴ This article will describe some ways in which corporate law does something similar, not through manipulating default rules, but rather through manipulating altering rules. In a libertarian paternalist way, the corporate law tries to protect shareholders by making it somewhat hard to opt out of some default rules, but still gives corporations real choice by not making the altering rules impossibly sticky. However, in doing so, corporate law is dealing with shareholder collective action problems, not with the concerns of libertarian paternalism literature regarding individual deviations from economic rationality.

The literature has paid less attention to how the law defines how parties may opt out of default rules. Ayres and Gertner still lead the discussion of this question.⁶⁵ They argue that there can be good reasons for having strong defaults which are costly to contract around.⁶⁶ Their analysis draws upon Lon Fuller's classic article *Consideration and Form*.⁶⁷ Fuller asserts three functions for contractual formalities: evidentiary, cautionary, and channeling.⁶⁸ The rules for opting out of a penalty default may structure the contractual process to ensure that the parties convey

61. See Michael E. Murphy, *The ESOP at Thirty: A Democratic Perspective*, 41 WILAMETTE L. REV. 655, 693 n.186 (2005) ("The Rochdale principles require, among other things, that membership in the cooperative be open to all persons who made use of its services, that management be democratically controlled by its members, and any profit remaining after the payment of costs be allocated to members on the basis of their patronage.").

62. See Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 287 (1998); Brett H. McDonnell, *Employee Primacy, Or Economics Meets Civic Republicanism at Work* (Legal Studies Research Paper Series, Research Paper No. 06-06), available at <http://ssrn.com/abstract=878790>.

63. See Cass R. Sunstein, *Human Behavior and the Law of Work*, 87 VA. L. REV. 205, 218 (2001).

64. See Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1172-86 (2003).

65. Ayres & Gertner, *supra* note 43, at 119-27.

66. See *id.* at 122-23.

67. *Id.* at 123 (citing Lon Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799 (1941)).

68. See *id.* at 124 (discussing Fuller's article).

meaningful information to one another.⁶⁹ The altering rules may serve a cautionary function by forcing parties, especially uninformed parties, to reflect before making a decision.⁷⁰ Finally, the rules can serve a channeling function by inducing corporations to sort themselves into different groups.⁷¹

III. THE BASIC THEORY

This Part begins with a variety of distinctions that should help in addressing the topic. First, recall the basic distinction between *default* and *mandatory* rules. Ayres and Gertner distinguish between default and what they call “immutable” rules as follows:

The legal rules of contracts and corporations can be divided into two distinct classes. The larger class consists of “default” rules that parties can contract around by prior agreement, while, the smaller, but important, class consists of “immutable” rules that parties cannot change by contractual agreement. Default rules fill the gaps in incomplete contracts; they govern unless the parties contract around them. Immutable rules cannot be contracted around; they govern even if the parties attempt to contract around them.⁷²

Whether to characterize a rule as default or mandatory is sometimes a contested point. Of perhaps greatest interest, we shall see that commentators disagree as to whether a director’s duty of loyalty to the corporation creates a mandatory or default rule.⁷³

The central concept for this paper is that of an *altering rule*. By “altering rule,” I mean the legal procedure required under the relevant law to opt out of a default rule in a way that the relevant jurisdiction will recognize as valid. As Ian Ayres, inventor of the term explains, “[a]ltering rules tell private parties the necessary and sufficient conditions for contracting around a default.”⁷⁴ The altering rule may make it easier or harder for a corporation to opt out of a default rule, and an altering rule that makes it harder to opt out is more “sticky.” This paper examines a wide range of stickiness in Part IV. At the least sticky, Teflon end of the spectrum, some defaults can be altered by the action of a simple majority of the board. Slightly stickier rules require a supermajority of the board. Stickier yet are altering rules that require approval by a majority of both the board and of voting stockholders. A bit stickier than that are rules that require approval by a majority of both the board and of the outstanding shares. Beyond that are rules which require supermajorities of the board and stockholders, up to the point of requiring unanimity of both. Altering rules can affect stickiness along a variety of other dimen-

69. *Id.*

70. *See id.*

71. *See id.* at 125.

72. *Id.* at 87.

73. *See infra* Part IV.D.

74. Ayres, *supra* note 6, at 6.

sions as well. Moreover, an important characteristic of altering rules is how they assign authority to parties within the corporation to decide whether and how to opt out of default rules.

One should also distinguish the stickiness induced by the relevant altering rule from a default rule's *background stickiness*. By the "background stickiness" of a default rule, I refer to a variety of legal and non-legal factors that make it more or less difficult for corporate actors to opt out of a rule given any particular altering rule. For instance, suppose an altering rule requires majority shareholder approval to opt out. Achieving majority shareholder approval may be easier or harder depending on the structure of ownership for a particular corporation, the type of shareholders, the rules governing proxy solicitation, and so on. The background stickiness of a rule may be different depending on which way the default rule is set. Thus, if the altering rule requires opting out through the charter, then a pro-board default rule will be more sticky than an anti-board rule because the board initiates charter amendments, and boards are unlikely to initiate changes to a pro-board default rule.⁷⁵

Lawyers and legal practice may importantly affect both background stickiness and the stickiness of a particular altering rule, which may evolve over time. Innovations in contracting practice may make it easier to opt out of a given default rule than was initially envisioned by the rule's creators. Thus, the stickiness of any given default or altering rule is a dynamic concept that may vary over time. For instance, the standard default rule is that a majority of the board and the shareholders of a corporation must approve its merger with another corporation. However, the creation of the triangular merger made it relatively easy for the boards of two merging corporations to avoid the shareholder approval requirement in many instances, at least with respect to the shareholders of the acquiring company.

Altering rules differ in their *scope*—they may be more or less general or broad. An altering rule may be specific to a given default rule or may cover many default rules. That is, sometimes, by invoking an altering rule, one may opt out of only one default rule, while in other cases, one may opt out of many default rules simultaneously. For example, consider the default rule for shareholder approval of mergers. In the Model Act, the default rule is that a merger requires the vote of a majority of the shareholders voting.⁷⁶ However, the articles of incorporation may require a greater than majority vote.⁷⁷ This is an altering rule with a narrow scope. A corporation can also alter the default rule by re-incorporating in a state with a different default rule regarding the approval of a merger. For instance, if a corporation in a Model Act jurisdic-

75. See Bebczuk & Hamdani, *supra* note 47, at 492 (arguing that default rules should be set against expanding board power because it will be easier to opt out of defaults set in that way).

76. MODEL BUS. CORP. ACT § 11.04(e) (2006).

77. *Id.* § 11.04(c), (e).

tion whose charter did not contain any specific provision concerning merger approval reincorporated in Delaware, then Delaware law would apply, requiring the approval of a majority of the outstanding shares for a merger.⁷⁸ In doing so, the corporation would simultaneously opt out of a number of other default rules where the Model Act and Delaware differ. Thus, the rule governing the approval required for reincorporation is a more general altering rule, because by re-incorporating, the corporation changes a variety of default rules (namely, it changes all the default rules that differ between the two states).

Both altering and default rules may be *tailored* or *untailored*. As Ayres and Gertner make this distinction:

A “tailored default” attempts to provide a contract’s parties with precisely “what they would have contracted for.” An “untailored default,” true to its etymology, provides the parties to all contracts with a single, off-the-rack standard that in some sense represents what the majority of contracting parties would want. . . . “Reasonable” defaults usually entail a tailored determination of what the individual contracting parties would have wanted because courts evaluate reasonableness in relation to the “circumstances” of the individual contracting parties.⁷⁹

For an example of a tailored altering rule, see the discussion of the duty of loyalty in Part IV.D below.

There are also *meta-altering rules*: rules by which a corporation may alter the rules required to alter the default rules that apply to it. For instance, many altering rules specify that a provision in a corporation’s bylaws or charter may change the legal default rule. Thus, a provision affecting the approval required to change the bylaws or charter is a meta-altering rule—it affects how the corporation may alter many relevant default rules. For example, Delaware law allows corporations to tailor shareholder rights, privileges, and preferences in different classes of shares in ways that differ quite widely from the plain traits of ordinary common shares as defined by the statutory default rules.⁸⁰ However, to vary from the defaults, the corporation must do so in the certificate of incorporation.⁸¹ Amending the certificate, in turn, generally requires approval by a majority of both the board and the outstanding shares.⁸² Thus, the basic altering rule for varying the rights and preferences among shareholders is that a majority of the board and shareholders is required. Nevertheless, the law allows corporations to impose a supermajority requirement for shareholder votes amending the certificate.⁸³ The procedure for changing the vote required for shareholder approval of

78. DEL. CODE ANN. tit. 8, § 251(c) (2007).

79. Ayres & Gertner, *supra* note 43, at 91–92.

80. See DEL. CODE ANN. tit. 8, § 151(a) (2007).

81. *Id.* The certificate may delegate broad authority to the board to issue classes of shares.

82. See DEL. CODE ANN. tit. 8, § 242 (2007).

83. See DEL. CODE ANN. tit. 8, §§ 102(b)(4), 242(b)(4) (2007).

amendments to the certificate is thus a meta-altering rule, as it allows the corporation to vary the altering rule that applies to this and a variety of other default rules.

It might be that some meta-altering rules are themselves mandatory, meaning that individual corporations may not alter them. For instance, in the certificate as meta-altering rule example, Delaware law requires a class vote for amendments which alter that class's power or preferences in a variety of specified ways, irrespective of whether the certificate grants or denies them such power.⁸⁴ Thus it might seem that a class vote right is an unalterable part of this particular meta-altering rule. We shall see, though, that appearance is deceiving. It turns out that there are other ways to in effect amend the certificate without going through the procedures that section 242 of the Delaware Code sets out, and those other ways allow corporations to avoid the class vote requirement.⁸⁵ At a higher level, a corporation can opt out of the altering and meta-altering rules that constrain it within a given state's law by either reincorporating elsewhere or by choosing another form of legal organization altogether.⁸⁶ Thus, few if any base rules, altering rules, or meta-altering rules can ever truly be mandatory.

Finally, another concept which one will find sometimes helpful is that of *menus*. A statutory scheme may offer businesses a menu of options at some point—there are multiple statutorily defined options that businesses may choose to follow.⁸⁷ At a high level, the choice between corporate law, partnership law, limited liability company law, and so on, provides businesses with a menu of options as to basic legal form.⁸⁸ Offering businesses a menu will usually decrease the cost of opting out of a default rule, as the business choosing to opt out has an already-constructed alternative available—it need not design one from scratch.

These distinctions help in both describing corporate law rules and in analyzing their desirability. This author defers the descriptive task largely to Part IV. There, we shall see that the above concepts help make sense of, and tie together, such topics as bylaws versus charter provisions, supermajority requirements, sunset provisions, fiduciary duties, the doctrine of independent legal significance, reincorporation, close corporation rules, non-corporate business entity rules, and public versus private corporations.

The remainder of this part considers general arguments for analyzing the optimal stickiness of various altering rules. Part IV applies those arguments to specific cases.

The prevailing contractarian approach to corporate law seems to suggest that altering rules should generally make opting out as easy as possi-

84. See DEL. CODE ANN. tit. 8, § 242(b)(2) (2007).

85. See *infra* Part IV.E.

86. See *infra* Part IV.F.

87. See Ayres, *supra* note 6, at 3; Listokin, *supra* note 58, at 1–9.

88. See *infra* Part IV.F.

ble, allowing corporations to easily adapt the rules to their specific circumstances or to correct mistakes made by the state in setting the default rule. The contractarian approach generally prefers to give the parties in the corporation as much room as possible to specify governing arrangements that they believe are best for them. Sticky altering rules create a risk that the corporation will be stuck with a bad default rule or may increase the costs required to opt out of a bad rule. Taken to an extreme, this would suggest that a majority of the board, acting alone, should be able to opt out of all default rules. That scenario requires a lot of faith that market mechanisms adequately discipline the board, however. As we shall see, a majority of the board can indeed opt out of many default rules, but far from all of them. It appears that even the most extreme of the contractarians have not called for such a Teflon set of altering rules. They at least implicitly seem to accept as appropriate that for many defaults, the altering rule calls for opting out through the charter rather than through the bylaws, thereby requiring approval by shareholders, not just the board. Thus, these contractarians seem to implicitly recognize the value in putting some brakes on the ability of corporations to opt out of default rules. Unfortunately, the traditional focus on the simple default/mandatory dichotomy has obscured this recognition.

Are there any reasons why one might sometimes want at least somewhat sticky altering rules? The literature on default versus mandatory rules presents three main types of justification for mandatory rules: protection of shareholders, externalities between corporations, and protection of third parties.⁸⁹ There is much debate over these justifications for mandatory rules. The main addition to the literature here is to point out that the same factors apply to thinking about the optimal stickiness of altering rules. Let us consider these three leading types of justifications for mandatory rules in turn.

First, shareholders may need protection from the board, from other parties, or from other shareholders.⁹⁰ Directors may use their authority to engage in self-dealing activities that benefit themselves at the expense of shareholders.⁹¹ Employees will also have plenty of chances to self-deal. Controlling shareholders may dictate decisions that benefit themselves at the expense of minority shareholders. A variety of factors make shareholders vulnerable to exploitation. This is especially true where there are a relatively large number of shareholders, each having rather small holdings. In such circumstances there is a serious free rider problem for shareholder collective action in attempts at self-protection.⁹² Furthermore, behavioral finance theory has suggested a variety of reasons why shareholders may not behave as rationally as conventional eco-

89. See generally Gordon, *supra* note 21, at 1556–69.

90. *Id.* at 1555–64.

91. *Id.*

92. See *id.* at 1575–77.

nomic theory suggests.⁹³ Many rules of corporate law, especially fiduciary duties, offer some protection against such exploitation. They do so by making altering rules somewhat sticky and putting power in shareholder hands to approve certain kinds of changes.

Of course, the shareholder protection comes at a cost, and in some cases, the cost may not be worth it. That is the crucial benefit of default as opposed to mandatory rules: default rules allow the corporation to opt out of overly costly rules. However, if the law makes opting out of the default too easy, then the very factors which call for shareholder protection may cause shareholders to allow the corporation to opt out of a protective rule, even though doing so harms shareholders. Discussion of shareholder protection has drawn a large distinction between charter provisions in place at the time a company goes public and those passed later. If one believes the efficient capital market hypothesis, then provisions in place at the time of an Initial Public Offering ("IPO") should be adequately priced in the company's stock, so that shareholders vulnerable to opportunism due to a particular provision may be compensated by paying a lower price.⁹⁴ At the time of the Columbia Symposium, even many participants who were less contractarian in approach largely bought this argument.⁹⁵ Today things are murkier, as the efficient market hypothesis has undergone some empirical battering,⁹⁶ although it still has plenty of defenders. Conversely, at the time of the Columbia Symposium, even many contractarians accepted that mid-stream charter changes after an IPO could reduce efficiency due to free rider problems and the ability of managers to strategically bundle unattractive charter changes with other matters.⁹⁷ In contrast, current-day shareholder activists seem to set much stock in the ability of shareholders to protect themselves through voting, insofar as many shareholder proposals now call for a larger role for shareholder voting—for example, majority voting for boards, shareholder access to the corporate proxy for nominating directors, and shareholder voting on executive compensation, to name several of the leading initiatives.

Although the discussion thus far assumes that those who believe that shareholders need strengthened protection will seek stickier altering rules, that is not always the case. In some circumstances, they seek less sticky altering rules. In particular, advocates of greater shareholder strength sometimes seek rules that allow shareholders to change default rules without board approval, making change easier than under the current regime. One sees examples of this in the shareholder bylaw debate⁹⁸

93. See generally ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* (2000).

94. See EASTERBROOK & FISCHEL, *supra* note 1, at 18–19.

95. See Gordon, *supra* note 21, at 1562–63.

96. See SHLEIFER, *supra* note 93; Michael Klausner, *Institutional Investors, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755 (2003).

97. See EASTERBROOK & FISCHEL, *supra* note 1, at 32–34.

98. See *infra* note 133 and accompanying text.

and in the discussion of reincorporation.⁹⁹ This illustrates an important feature in examining altering rules we should consider—not just their stickiness, but also how they allocate authority.

The second justification for mandatory disclosure rules is that there may be externalities between corporations. Investors will find disclosure more useful if they can compare similar information presented in similar form across different companies.¹⁰⁰ Companies may not achieve the optimal coordination on their own, so the state might be able to improve things by imposing a uniform set of disclosure requirements on all companies of a relevant type.

However, this too comes at a cost. The state may require overly extensive or unnecessary disclosure, and gathering the information may have costs that outweigh the benefits. Moreover, companies may be able to coordinate without state intervention, for instance, through stock exchanges and exchange rules. For decades a debate has raged among securities law scholars about the relative benefits and costs of mandatory disclosure.¹⁰¹ Here too, having default rules with somewhat sticky altering rules may be a useful compromise. Companies will choose to follow the default required disclosure as long as it is not too costly, in order to avoid the cost of opting out. If the disclosure becomes too costly, however, companies will be able to opt out.

Third, corporate law rules may protect third parties. Creditors are perhaps the leading example, since a variety of corporate law rules exist to help protect creditors. Piercing the corporate veil is one example.¹⁰² Legal capital rules are another.¹⁰³ The duty to creditors that arises in the zone of insolvency is a third.¹⁰⁴ Here again, though, the social costs of these rules (taking into account all corporate constituencies that they affect) may in some cases outweigh their social benefits, creating a problem if the rules are mandatory. Allowing opting out, but making such opting out somewhat hard, is again an attractive option.

Ayres and Gertner provide a somewhat different way of thinking about what one might gain from sticky altering rules. As noted above, they describe possible benefits from stickiness using Lon Fuller's classification of rules as serving evidentiary, cautionary, and channeling functions.¹⁰⁵

99. See *infra* notes 228–63 and accompanying text.

100. See EASTERBROOK & FISCHEL, *supra* note 1, at 25–26.

101. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 680–85 (1984); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1341–42 (1999).

102. See Stephen B. Presser, *The Bogalusa Explosion, "Single Business Enterprise," "Alter Ego," and Other Errors: Academics, Economics, Democracy, and Shareholder Limited Liability: Back Towards a Unitary "Abuse" Theory of Piercing the Corporate Veil*, 100 NW. U. L. REV. 405, 411–415 (2006).

103. See generally BAYLESS MANNING & JAMES HANKS, *LEGAL CAPITAL: BEING A CONCISE PRACTICAL EXPOSITION WITH ILLUSTRATIVE EXAMPLES* (3d ed. 1990).

104. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, Civ. A. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991).

105. See *supra* notes 65–72 and accompanying text.

The cautionary function seems very closely related to the goal of protecting shareholders. Given imperfectly efficient markets and collective action and rational apathy problems, one is concerned that shareholders in public corporations may agree to rules that hurt their interests. By imposing a higher hurdle to the passage of suspect rules, the law requires a more considered judgment from shareholders.

The evidentiary function of altering rules points one to their possible use in information-forcing. In most corporations, especially public corporations, the officers and directors are likely to have better information than shareholders. One may want to craft rules in ways that encourage the managers to reveal this information. This may sometimes justify pro-shareholder defaults backed by somewhat sticky altering rules. Consider, for instance, the adoption of antitakeover mechanisms. Whether or not such mechanisms are good for a particular corporation may depend on non-public information that managers possess. If the default rule already protects against takeovers, then even managers who know that there is less benefit to them than to others from avoiding takeovers are unlikely to opt out, as they generally receive *some* private benefits from takeover protection, and shareholders are also unlikely to opt out. Using instead a default rule of no takeover protection, managers must opt out. If we make this opt out somewhat difficult, by requiring shareholder approval, then the managers will need to reveal information to shareholders about the benefits of takeover protection in order to induce the shareholders to agree to opt out. The harder the altering rule makes it to opt out, the more pressure there will be on the managers to reveal their information.¹⁰⁶ Of course, information revelation is not always in the best interests of the corporation—for instance, some information may be useful to competitors.

Altering rules may induce corporate actors to sort themselves into different groups, which Ayres and Gertner label the channeling function.¹⁰⁷ Ayres and Gertner relate this function to the external effect on third parties justification for sticky rules.¹⁰⁸ A corporate rule may hurt creditors, especially involuntary creditors, and hence one may want to discourage that rule.¹⁰⁹ However, if the benefits to shareholders or other insiders are great enough, the law may want to allow some corporations to follow the choice that hurts creditors.¹¹⁰ Making it hard and costly to adopt such a rule will then channel most corporations into the choice that does not hurt creditors, but allow those for whom such a rule is costly to sort themselves out from the majority.¹¹¹

106. This is related to the Bebchuk and Hamdani argument, see *supra* note 47, at 492–93, but goes a bit further. They argue that rules should be set in a way that is most likely to lead to opting out of inefficient rules. My point here is a bit different: sometimes one may want to make opting out more difficult in order to induce information revelation.

107. See Ayres & Gertner, *supra* note 43, at 125.

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.*

Understanding that default rules may come in varying degrees of stickiness, rather than seeing a stark choice between default and optimal rules, brings many conceptual benefits. The concepts of stickiness and altering rules suggest that the distinction between default and mandatory rules is not as sharp as often thought—a mandatory rule is just a very sticky default rule. One can thus describe and classify corporate law rules with more nuance and subtlety.

This greater nuance and subtlety brings more than just descriptive benefits, since it also suggests that the law can achieve greater efficiency than a stark mandatory/default dichotomy would allow. There are tradeoffs to making a rule stickier—shareholders or third parties may thereby be protected, but it becomes harder to opt out of a default that is either generally bad or inappropriate for a particular corporation. The availability of intermediate degrees of stickiness may allow lawmakers to strike a better balance in making such tradeoffs. Teflon defaults and completely mandatory rules are what economists call corner solutions—cases where given a choice along some range of possibilities, one chooses one of the extreme end points. Sometimes corner solutions are optimal, but usually they are not.

Note too that there is an interaction between how one sets the underlying default rule and how one sets the altering rule. For instance, if one sets a penalty default (that is, a default that achieves a bad outcome for one side with private information in order to induce that party to reveal information by opting out), then one probably will want to have an altering rule that is not at all sticky.¹¹² After all, the whole point of a penalty default rule is to induce the parties to opt out of it, so it should be made easy to opt out of such a rule. In another example, if we are trying to protect shareholders from possible board misdeeds, then we will want at least a somewhat sticky altering rule if the underlying default rule is pro-shareholder, but a quite non-sticky rule if underlying default rule is pro-board.¹¹³

IV. APPLICATIONS

Distinctions and theory in mind, this paper now considers some of the most important general categories of altering rules. For each type of rule, the paper evaluates both descriptive and normative questions. Descriptively, it considers ways in which the rules may be more or less sticky, how corporate law typically varies the stickiness for different kinds of cases, and whether and how that stickiness varies across jurisdictions. Normatively, it asks how sticky the rules should be. The paper addresses many different ways in which corporate law sets altering rules: bylaw and charter provisions, supermajority provisions, sunset provisions, fiduciary duties, the doctrine of independent legal significance, rules concerning

112. See Ayres & Gertner, *supra* note 43, at 125.

113. See Bebchuk & Hamdani, *supra* note 47, at 492.

reincorporation, close corporation rules, changing legal entity form, and public versus private corporations.

A. BYLAW AND CHARTER PROVISIONS

This part begins its analysis with bylaws versus charters, which are the two main governing documents for specific corporations. Perhaps the most common means for opting out of most corporate law default rules is through amendments either to the bylaws or the charter. Corporate law codes are replete with phrases such as “except as otherwise provided in the certificate of incorporation. . . .” or “except as otherwise provided in the certificate of incorporation or the bylaws. . . .” These phrases set the altering rule for the default rule that follows or precedes the phrase. Of much importance is whether the phrase mentions just the charter or both the charter and the bylaws.¹¹⁴ The crucial difference between them is that changes to the charter must be initiated by a majority of the board and then approved by a majority of shareholders. In contrast, shareholders acting alone, without the board, can amend the bylaws, and in most corporations, the board acting alone can amend the bylaws as well.¹¹⁵ Thus, an altering rule that allows opting out of a default through either the charter or the bylaws is significantly less sticky than one that allows opting out only through the charter.¹¹⁶ Such rules also differ in how they allocate authority between boards and shareholders, though in a somewhat complicated way. Altering rules that require a charter provision for opting out require boards and shareholders to agree before opting out; both have veto power, although only the board may initiate a charter amendment. In contrast, altering rules that allow opting out to occur in the bylaws allow the shareholders and the board to act on their own, without the agreement of the other.

Many corporate law defaults can be altered in the bylaws, but some defaults can be altered only in the charter.¹¹⁷ Table 1 lists a large number of provisions for which the Delaware General Corporation Law specifically provides that the default legal rule can be altered in either the certificate or the bylaws, and whether the law allows for altering in either the certificate and the bylaws, or just in the certificate. Note how many of these provisions allow for altering only in the certificate. In a prior paper,

114. Logically, the phrase could mention just the bylaws. However, nowadays, most if not all states provide that anything that can be done in the bylaws can also be done in the charter, so such a phrase is equivalent to a phrase mentioning both. *See* DEL. CODE ANN. tit. 8, § 102(b)(1) (2007); MODEL BUS. CORP. ACT § 2.02(b)(3) (2006).

115. *Compare* DEL. CODE ANN. tit. 8, § 242(b)(1) (2007), *with* DEL. CODE ANN. tit. 8, § 109(a)(2007); *and* MODEL BUS. CORP. ACT § 10.03(a)–(b), (d)–(e) (1979), *with* MODEL BUS. CORP. ACT § 10.20(b) (1979).

116. At least such a rule is significantly less sticky for some corporations. Where there is a majority shareholder, obtaining shareholder approval of an amendment to the charter should generally be easy, but where there is no controlling shareholder and many dispersed shareholders, obtaining shareholder approval can be quite costly, even for non-controversial matters.

117. *See* Table 1.

I have tried to make sense of when the bylaws can or cannot be altered. The pattern is not particularly easy to discern.¹¹⁸ An important matter of ongoing debate is whether and when shareholder bylaws may limit the broad discretionary power of the board. The best available suggestions are that bylaws can be used to address procedural issues and questions of general corporate governance, but not substantive business matters which are left to the power of the board.¹¹⁹

A variety of default rules that can specifically be altered through the bylaws seem to fit this pattern. For instance, the bylaws can set the number of directors, set a quorum for board action, restrict the ability of the board to meet by phone, specify officer duties and titles, and set the location for shareholder meetings.¹²⁰ Why does the law let corporations change these sorts of rules in their bylaws? Part of the reason may be that many of these provisions seem relatively innocuous, at least most of the time, and there is no particularly strong policy reason favoring the particular default rule set in the law. Making it easy to change the default is thus desirable; indeed, boards often fine tune many rules in the bylaws.

Why, though, should one not allow the bylaws to infringe on board power in deciding substantive business matters? This is harder to explain. It is relatively easy to explain why, in most instances, one would not want shareholders involved in such matters—shareholders lack the time and expertise, and shareholder decisionmaking is slow and expensive. However, shareholders presumably recognize these limitations on their own ability to act and would rarely want to enact bylaws dealing with ordinary business matters. Why not allow them to do so on those rare instances when they want to?

It is not very easy to answer this question within a pure contractarian framework. Perhaps the best answer currently lies in the work of Stephen Bainbridge, who terms himself a contractarian, though he really is not. Following the work of Kenneth Arrow,¹²¹ Bainbridge stresses the importance of board authority for efficient decisionmaking.¹²² If the law makes it too easy for shareholders to challenge any given exercise of authority, then the law has effectively eliminated that authority, even if shareholders do not choose to exercise that power often.¹²³ However,

118. See Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L. J. 205, 223 (2005).

119. See John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605, 616–19 (1997); McDonnell, *supra* note 118, at 217; but see Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 443–44 (1998).

120. See Table 1.

121. See generally KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* (1974).

122. See STEPHEN BAINBRIDGE, *CORPORATION LAW AND ECONOMICS*, ch. 5 (2002) [hereinafter BAINBRIDGE, *CORPORATION LAW AND ECONOMICS*]; Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 568–72 (2003) [hereinafter Bainbridge, *Director Primacy*].

123. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS*, *supra* note 122, at ch. 5; Bainbridge, *Director Primacy*, *supra* note 122, at 571–74.

that is not a completely satisfying explanation for why one might limit the ability of corporations to define the bylaw power quite widely. Even if the default scope of the bylaw power is inefficiently broad, corporations can deal with this problem by narrowing the scope of the bylaw power in the charter, which trumps the bylaws. According to the Bebchuk and Hamdani argument that default rules should be set in a pro-shareholder way because inefficient pro-shareholder defaults are more likely to be opted out of than inefficient pro-management defaults, it would seem that the corporate law should define the bylaw power quite broadly.¹²⁴

It is also enlightening to consider the cases where corporate law specifically allows opting out of a default rule through the charter but not the bylaws. Consider the following provisions of Delaware law:

- The certificate, but not the bylaws, may give a class of shareholders the right to elect one or more directors;¹²⁵
- The certificate, but not the bylaws, may limit the ability of shareholders to act by written consent;¹²⁶
- The certificate, but not the bylaws, may vary the one share/one vote rule;¹²⁷
- The certificate, but not the bylaws, may define the rights and powers of classes of stocks and stock-based rights in a variety of ways.¹²⁸

Why are these powers, among others, given to the certificate but not the bylaws? I hypothesize the following.¹²⁹ In all, or virtually all corporations, the board is able to amend the bylaws acting on its own. Thus, placing a particular default within the power of the bylaws to alter is ambiguous in how it affects the distribution of power between the board and the shareholders. The power to initiate bylaw changes is one of the few powers that shareholders have, so in that sense, expanding what can be done within the bylaws strengthens shareholder power. Nevertheless, placing a particular power within the scope of the bylaws also threatens to unduly expand board power because the board can amend the bylaws without shareholder approval. In the case of the provisions just listed, perhaps the lawmakers decided that the danger of giving those powers to boards acting alone was too great—boards could readily use them to entrench themselves.

124. See Bebchuk & Hamdani, *supra* note 47, at 492.

125. DEL. CODE ANN. tit. 8, § 141(d) (2007). For this and the other listed provisions here that provide for altering through the certificate but not the bylaws, the statutory language does not specifically say that the bylaws may not alter this default. Rather, the statute simply says that “[t]he certificate of incorporation may confer upon holders of any class or series of stock the right to elect 1 or more directors” The denial of this power to the bylaws is by negative implication, but that implication is quite strong, particularly given the many other provisions nearby in the statute which grant an altering power to both the certificate *and* the bylaws.

126. DEL. CODE ANN. tit. 8, § 211(b) (2007).

127. DEL. CODE ANN. tit. 8, §§ 212(a), 215(b) (2007).

128. DEL. CODE ANN. tit. 8, §§ 151, 157 (2007).

129. See McDonnell, *supra* note 118, at 221–22.

This explanation leaves open the question as to why the law does not allow altering the default rule through shareholder-passed bylaws but not board-passed bylaws. That strategy eliminates the threat of board entrenchment through bylaw amendments while still allowing shareholders to use the bylaws for self-protection. Occasionally, one does see such provisions in the law: an example is the Delaware rule that allows staggered boards to be established through shareholder-passed bylaws, but not board-passed bylaws.¹³⁰ It is rather puzzling why one does not see provisions of that sort more frequently in the corporate laws.

The basic rules for how corporations can amend their bylaws and charters become important meta-altering rules. Since the altering rule for many default rules recognizes opting out through a corporation's charter and perhaps through its bylaws as well, the rules that dictate how corporations may change their charters or bylaws in turn dictate how easy or hard it will be to opt out of many default rules. In comparing American rules for amending the corporate charter with those of many other countries, one sees an important difference in this meta-rule. In American states, amending the charter requires approval of both the board and the shareholders, with the rule nowadays generally requiring the approval of a majority of each.¹³¹ Some other countries, including the United Kingdom ("U.K."), allow the shareholders acting alone to amend the charter. In the U.K., the shareholders may amend the memorandum or articles of association (the British charter documents) without board approval. However, the law imposes a seventy-five percent supermajority requirement.¹³²

Comparing the stickiness of these American and British altering rules is a bit tricky—in some sense the American rule is stickier, in that it requires board as well as shareholder approval, while in another sense the British rule is stickier, in that it imposes a supermajority requirement. The British rule has an important shareholder protection advantage. By allowing shareholders to change many important corporate governance provisions without board approval, the British rule provides a potentially quite useful tool for shareholders unhappy with an entrenched board. For this reason, some American corporate law scholars have called for a similar rule here.¹³³ On the other hand, the supermajority requirement limits this pro-shareholder tendency, and may for some corporations make it quite costly to make even non-controversial and clearly beneficial charter changes. A supermajority requirement may also help entrench incumbent boards against hostile takeovers.¹³⁴

Note this recurring pattern.¹³⁵ For the most part, market enthusiasts

130. DEL. CODE ANN. tit. 8, § 141(d) (2007).

131. See *supra* note 115 and accompanying text.

132. See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 847–48 (2005).

133. See *id.* at 865–68.

134. See *infra* note 151 and accompanying text.

135. See *infra* note 151–54, 225 and accompanying text.

argue for less sticky altering rules, and market skeptics who want to protect shareholders argue for stickier altering rules. There is certainly a strong element of that dichotomy in the pattern of debate over the scope of bylaws. But, sometimes those who want greater protection for shareholders will actually advocate less sticky rules than the status quo, in the sense that they want shareholders to be able to alter the default rules without board involvement. That is true for scholars and shareholder activists who advocate a broad scope for shareholder bylaws.

B. SUPERMAJORITY PROVISIONS

Next, consider supermajority provisions in corporate law. Whether the change is to the bylaws, the charter, or a shareholder agreement,¹³⁶ a question arises as to how many shareholders (or directors, for that matter) must approve a provision opting out of the legal default rule. Is a mere majority enough, or is some super-majority or unanimity required? An additional question is whether the percentage approval required is a percentage of those actually voting or a percentage of those eligible to vote. The latter is of course tougher to meet.

A very common approach in modern corporate law is to require a simple majority of those voting in order to opt out of a particular default rule. That, for instance, is the Model Act's rule for amending the bylaws or the charter.¹³⁷ As demonstrated in Part IV.A, amendments to the bylaws or the charter are the main way of opting out of many corporate law default rules.¹³⁸ In the Model Act, a simple majority of those voting is also the rule for shareholder approval of mergers,¹³⁹ which acts as an important altering rule insofar as mergers are the way that corporations reincorporate into other states.¹⁴⁰ In Delaware, however, certificate and bylaw amendments and mergers must be approved by the holders of a majority of the outstanding shares.¹⁴¹ In corporations with a large and dispersed shareholder base, requiring a majority of the outstanding shares, rather than the voting shares, can be a considerably more difficult and costly requirement to meet, as many shareholders do not vote due to rational apathy.¹⁴² Some states still require a two-thirds vote for merg-

136. A shareholder agreement is a common method of structuring shareholder relationships within the corporation in closely held corporations.

137. See MODEL BUS. CORP. ACT §§ 10.03(e) (amendments to articles of incorporation), 10.20, (amendments to corporation's bylaws), 7.25(c) (quorum requirement) (1979).

138. *Id.*

139. MODEL BUS. CORP. ACT §§ 7.25(c), 11.04(e) (1979).

140. See *infra* Part IV.F.

141. DEL. CODE ANN. tit. 8, §§ 109(a) (bylaws), 242(b)(1) (certificates), 251(c) (mergers) (2007).

142. Bernard Black argues that the difference is practically unimportant, saying, "I know of no merger proposal involving a public company that failed despite being favored by a majority of those voting." Black, *supra* note 33, at 552. Even if this piece of casual empiricism is right, it does not necessarily mean the different voting requirements have no effect. Managers may tailor proposals they present to shareholders based on the difficulty in obtaining approval—the stronger the approval requirement, the more managers will be encouraged to present proposals that most shareholders will favor.

ers.¹⁴³ Traditionally, a merger required a unanimous shareholder vote.

A unanimity requirement still remains for some shareholder actions in some jurisdictions. For instance, under the Model Act, all shareholders must approve a shareholder agreement provision that limits the authority of the board to manage the business of the corporation.¹⁴⁴ This is (or was) also the common law approach to such provisions in a variety of states.¹⁴⁵

Here one sees that one can achieve a broad range of stickiness, varying with the size of the majority required. At one end of the spectrum, the law can require a simple majority of those voting, the least sticky rule. At the other end one has a unanimity requirement—a prohibitively costly requirement for most public corporations. In between is a potentially infinite variety of supermajority requirements, although two-thirds is the mostly frequently observed. Also in between is the requirement pertaining to the makeup of the majority—that it be of all eligible shares, not just those actually voting. There is ambiguity in comparing the degree of stickiness of the latter two sorts of provisions—is it easier to reach two-thirds of those voting or one-half of those eligible to vote? The answer may differ for different corporations, depending on their shareholder base. The trend over time has been from super-majority requirements to simple majority requirements, but in many states some important decisions, such as mergers, still require a super-majority, and in a few instances, even unanimity.¹⁴⁶

What might explain those provisions which still, in some states, have supermajority or unanimity requirements?¹⁴⁷ The two main sorts of decisions that have such requirements are mergers and shareholder agreements restricting board power. Consider mergers first. There are several possible shareholder protection justifications for supermajority approval restrictions for mergers. First, mergers are the main way in which corporations reincorporate in other states.¹⁴⁸ They are also a means for changing from a corporation to another form of business association or vice versa.¹⁴⁹ Mergers are thus a rather general altering rule, because through reincorporating, a corporation in one stroke succeeds in changing all of

143. See, e.g., MO. REV. STAT. § 351.425 (2001).

144. MODEL BUS. CORP. ACT § 7.32(b) (1979).

145. See *Glazer v. Glazer*, 374 F.2d 390, 405–13 (5th Cir. 1967).

146. See *supra* notes 143–45 and accompanying text.

147. Supermajority provisions are of great importance in other areas of the law. Michael Rappaport and John McGinnis have argued that much of the value of the U.S. Constitution can be seen in its supermajoritarian provisions. See John O. McGinnis & Michael B. Rappaport, *Our Supermajoritarian Constitution*, 80 TEX. L. REV. 703, 707 (2002) (“Supermajority rules can improve decisionmaking when special interests can use their power to secure provisions that would not otherwise pass under majority rule, when provisions are being considered that are designed to operate for long periods or need to have wide support, and when political passions can cause majorities to make harmful decisions.”). Different considerations apply to federal constitutions as compared with corporate charters.

148. See *infra* Part IV.F.

149. See *infra* Part IV.F.

the default rules that differ between the two states. Insofar as some states have significantly less shareholder-friendly default rules than other states, such reincorporation mergers threaten to destroy shareholder value. Given rational apathy and ignorance problems in shareholder voting, it might make some sense to protect against value-destroying reincorporation mergers by imposing a supermajority requirement.

I doubt that the above is the main justification for merger supermajority requirements, however. Rather, a different shareholder protection justification seems dominant. A merger can potentially make a huge change in the nature of a shareholder's investment. Such change is forced upon those shareholders who do not approve the merger. Lawmakers might be reluctant to allow boards to force a large percentage of shareholders to accept a new investment.¹⁵⁰ Indeed, this rationale was the source of the old rule requiring unanimous shareholder approval of mergers. The problem with that rule is that for corporations with enough shareholders, it will effectively block even clearly beneficial mergers due to hold-out problems. An intermediate supermajority requirement should greatly lessen the hold-out problem while still providing more shareholder protection than a simple majority of those voting requirement. Here is a nice example of how an intermediate degree of stickiness in an altering rule can trade off the benefits and costs of more or less sticky extremes. Whether some sort of supermajority requirement is actually optimal in the case of mergers is not clear, and states differ in their rules regarding mergers. One should particularly note the logic of how a moderately sticky altering rule can potentially lead to a better outcome.

It is trickier to explain and justify the unanimity requirement for shareholder agreements limiting board authority. This is another example of how corporate law views with disfavor attempts to limit board authority from the broad power granted to boards as a default matter. This paper already confronted this issue in discussing the scope of the bylaw power.¹⁵¹ Beyond that discussion, another element affecting courts' consideration of such shareholder agreements is their potential for use by a majority of shareholders to oppress a minority group. Where all shareholders have agreed to a provision, minority oppression is clearly not the intended use (or result) of the agreement, and so courts are less reluctant to enforce the provision. That conclusion apparently motivated the court in *Clark v. Dodge*,¹⁵² a leading early case which permitted a shareholder agreement restricting board powers. However, plenty of such agreements are used to protect minority shareholders, and yet courts still traditionally viewed such agreements with suspicion.¹⁵³

150. Of course, dissenting shareholders can always seek an appraisal remedy. However, this remedy is often of quite uncertain value.

151. See *supra* Part IV.A.

152. *Clark v. Dodge*, 199 N.E. 641, 643 (N.Y. 1936).

153. See, e.g., *McQuade v. Stoneham*, 189 N.E. 234, 239-40 (N.Y. 1934).

A further complication is that the simple majority or supermajority altering rules of corporate law are often themselves defaults—they are default altering rules that can themselves be altered by individual corporations, typically through charter provisions. Corporate codes typically allow the charter to increase the majority required to take a given action above the level required under the code itself. This raises a further question: are there dangers involved in allowing the corporation to alter the majority required under the law, and if so, what kind of shareholder vote should suffice to change the default rule?

There is a difference between increasing and decreasing the majority required. As this paper has illustrated, supermajority requirements typically work as a form of shareholder protection, either for all non-management shareholders against managers, or for a minority of shareholders against a controlling shareholder or group. Thus, moves to *reduce* the majority required for an action are more problematic than moves to *increase* the majority required. This is because moves to reduce may well be attempts to facilitate the very kind of exploitation which the supermajority requirement is designed to address, whereas the costs associated with increased supermajorities are hold-out and related problems that the state should be less concerned about if the shareholders themselves decide to approve the increased majority.¹⁵⁴ Indeed, to my knowledge, the corporate law provisions that allow variance from the default legal majority required typically allow individual corporations to increase the majority required, but not to decrease it.¹⁵⁵ Moreover, where the charter has already imposed a majority requirement greater than the legal level, the law typically requires that a vote to reduce that voting percentage requirement must receive at least the share of votes required by the requirement that is being amended.¹⁵⁶ Thus, if shareholders at an earlier point have chosen to protect themselves with a supermajority requirement, the law enforces this by not letting later shareholders overturn that protection with a simple majority vote. Any other rule would make supermajority provisions in individual corporate charters rather pointless because they would be too easy to get around.

The most problematic point concerning supermajority provisions in individual corporate charters is what kind of vote should be required to increase the majority required above the legal default level? Should it be a simple majority vote, or rather a majority at least as large as the major-

154. This statement requires a major caveat, to which I shall turn shortly.

155. See, e.g., DEL. CODE ANN. § 242 (2007); MODEL BUS. CORP. ACT § 7.27(a) (1979). A related partial exception is provisions which allow the certificate to raise or lower the board quorum requirement. See, e.g., DEL. CODE ANN. § 141(b) (2007); MODEL BUS. CORP. ACT § 8.24(b) (1979) (although these typically do not allow reducing the quorum below one-third). Board quorum requirements are less prone to exploitive use against shareholders than shareholder voting requirements. On submajority rules, see Adrian Vermeule, *Submajority Rules: Forcing Accountability Upon Majorities*, 13 J. POL. PHIL. 74 (2005).

156. See DEL. CODE ANN. § 242(b)(4) (2007); MODEL BUS. CORP. ACT § 7.27(b) (1979).

ity requirement sought to be imposed? Some jurisdictions take the former approach,¹⁵⁷ while others take the latter.¹⁵⁸ Given the logic so far, there would seem to be no harm in allowing a simple majority to raise the majority requirement. If the point of a supermajority is to protect shareholders, why not make it easier for shareholders to decide to do so? However, the most common use of supermajority charter provisions in public corporations today is as a form of antitakeover defense. This is potentially a form of managerial entrenchment that may hurt, not help shareholders. If that concern is great enough—and I suspect it is—it probably justifies the Model Act approach of requiring a supermajority in order to enact a supermajority.¹⁵⁹

The diminished use of supermajority rules in corporate codes reflects the contractarian trend in the law. Nevertheless, the continued existence of a variety of supermajority rules shows that trend has not (yet?) reached its logical conclusion. This paper just explored a variety of still-existing supermajority rules that help protect shareholders. Here too, though, greater stickiness is not always a pro-shareholder trait. Some antitakeover statutes create supermajority requirements as a way of protecting incumbent managers.

C. SUNSET PROVISIONS

Another possible way of making an altering rule stickier is through a sunset provision. Such a provision says that a change from the default rule only applies for a given period of time; after that, the change must be re-approved, or the corporation reverts to the default. Some states have sunset provisions for certain kinds of shareholder agreements, and on the (I believe rare) occasion, one finds state law imposing sunset provisions for certain charter matters. Such charter sunsets are a useful avenue to explore further if, like me, one worries that many companies may be going public with suspect provisions in their charter.

The Model Business Corporation Act contains one of the most significant current versions of a sunset provision. Unanimously agreed-upon shareholder agreements may limit board authority. However, a shareholder agreement provision imposing such a board authority limit becomes invalid after ten years unless renewed.¹⁶⁰ The strength of this rule is seriously diluted though by the fact that the shareholder agreement may vary the term of the sunset length, or eliminate it altogether.¹⁶¹

Another fairly common sunset provision concerns voting trusts. In such trusts, shareholders give a trustee legal ownership of their shares, including the right to vote the shares, but retain beneficial ownership. Corporate law has traditionally looked upon voting trusts with disfavor

157. See DEL. CODE ANN. § 242 (2007).

158. See MODEL BUS. CORP. ACT § 7.27(b) (1979).

159. *Id.*

160. See MODEL BUS. CORP. ACT § 7.32(b)(3) (1979).

161. See *id.*

and imposed a variety of restrictions upon them. One such restriction is that a trust may last for only a certain period of time, typically ten years. Delaware used to have such a rule, although it no longer does. The Model Act still has a ten year limit on voting trusts.¹⁶²

A notable past example of a sunset rule for a specific kind of charter provision is the former North Carolina Business Corporation Act section 16(3). This provided that charter provisions granting performance-based bonuses to executives would be valid for only five years unless renewed by a shareholder vote.¹⁶³ That statute was enacted to address the perceived problem in the famous case of *Rogers v. Hill*, in which executives received bonuses tied to a share of profits which, over time, with the rapid growth of the business, became extraordinarily large.¹⁶⁴ The theory of the North Carolina provision is that the shareholders did not intend the executive compensation to grow so large, but that once such a provision was in place it was hard to change. The sunset rule forced shareholders and managers to address the compensation question again. If they still believed the compensation was proper, they could renew the provision, but they would have to affirmatively act to do so.

Sunset rules may be an attractive way to address several kinds of problems that may arise in some kinds of charter provisions. The core problem is that the board retains control over the process of amending the charter. If the board does not choose to initiate the amendment process, no change can occur. Thus, if a company's charter comes to contain an inefficient but pro-management provision that the board does not want to amend, then shareholders may have trouble getting rid of such a provision.

Of course, if one believes that through a variety of mechanisms, directors are properly motivated to pursue efficient corporate governance strategies, this is not a problem. Nevertheless, there is good reason to believe that not all boards are always so motivated—indeed, many boards seem to fall well short of a faithful devotion to shareholder interests.¹⁶⁵ If so, then sunset rules may provide a relatively unobtrusive, non-paternalistic way of addressing inefficient pro-management provisions. Simply banning provisions that allegedly fit that description is problematic because lawmakers may not do a good job identifying which provisions are truly inefficient. Moreover, some provisions may be inefficient for some corporations but efficient for others, and so banning them may impose unwanted costs on those corporations for which the provision does make sense. A sunset rule gives shareholders a chance to periodically review a suspect kind of provision. If a majority (or whatever level of approval is

162. See MODEL BUS. CORP. ACT § 7.30(b) (1979).

163. See JESSE H. CHOPER ET. AL., CASES AND MATERIALS ON CORPORATIONS 142 n.76 (5th ed. 2000).

164. *Rogers v. Hill*, 289 U.S. 582, 591–92 (1933). By the norms of the time, the bonuses were extremely large. Times change.

165. See generally LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

required—see Part IV.B) continues to approve the provision, then it will remain. If not, it is eliminated.

Several questions arise. How do charters come to contain inefficiently pro-manager provisions in the first place? Is this really a systematic problem? After all, shareholders have to approve the provisions in the first place—Why would they do so? There are several possible sources for such provisions. First, shareholders could simply have made a mistake initially, and then learned from experience that the provision in question was not good. People make mistakes, and given the disincentives for most shareholders in a public corporation to pay close attention to corporate governance matters, such mistakes should not be surprising or uncommon.¹⁶⁶ Second, a provision may not be problematic when enacted, but then become inefficient over time. Some allege that this occurred with staggered boards, which only became a powerful antitakeover tool at some point in the 1980s.¹⁶⁷

Third, it is possible that charters may contain inefficient provisions at the time a company goes public. This goes against received wisdom. Most corporate law scholars in recent decades, since the influence of economics became strong, have believed that capital market efficiency would impose a cost on corporate founders who went to market with inefficient charter terms, forcing them to charge less for their shares than they otherwise would and hence forcing them to internalize the expected costs of problematic terms.¹⁶⁸ Since the founders would internalize the costs imposed on shareholders, they would have the proper incentive to set terms efficiently. However, more recently many scholars have come to question whether capital markets work efficiently enough for that argument to have the full force it was once thought to have. If markets, particularly the markets for IPO stock, do not work that efficiently, then they will not effectively price in the expected costs of inefficient charter provisions.¹⁶⁹

Still, even if one grants that there may be a systematic problem, are sunset rules really likely to work as a solution? After all, they rely upon shareholder voting, and due to the disincentive of shareholders to inform themselves, can this mechanism really work? Worse, might it not open up corporations to manipulation and extortion by special interest shareholders? These may be problems, but they seem unlikely to doom the sunset rule idea. As to misinformed shareholder voting, with the growth of institutional shareholders, at least a fair number of shareholders nowadays do have enough at stake to pay some attention, and those shareholders are aided by consulting services such as ISS.¹⁷⁰ Moreover, the types of provi-

166. Of course, as this paper shall soon explore, this in turn raises a question as to the efficacy of sunset rules, which rely on shareholder voting to correct problems.

167. Lucian Arye Bebchuk et. al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 940–44 (2002).

168. The argument goes back to Jensen & Meckling, *supra* note 9.

169. See Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 716 (2003); Klausner, *supra* note 96.

170. See ISS Consulting, <http://www.iss-consulting.com/> (last visited June 23, 2007).

sions at issue will generally raise issues that recur across corporations, so experienced shareholders can develop policies as to how to vote on them. As to special interest shareholders, they are generally only a minority within most corporations, and they must attract the support of others in order to prevail. They may try to do so, but management can lobby too, and in most corporations where the management is at all decent, most shareholders are, if anything, inclined to defer too much to management, not too little.¹⁷¹ Thus, sunset rules will be far from a perfect fix—many inefficient provisions may still be renewed due to over-deference to management, and occasionally special interest shareholders may succeed in using the vote against the interest of the majority. However, the voting mechanism seems likely to work well enough most of the time that it should be able to weed out at least the most objectionable charter provisions subject to such sunset rules.

What sorts of provisions should be subject to such sunset rules? The most obvious candidates are provisions that help entrench boards. Above all, staggered boards, the most significant entrenchment mechanism,¹⁷² should probably be subject to a sunset rule.

Are the financial costs of sunset rules likely to outweigh their benefits? There will be some costs, as corporations will need to include renewal proposals in the corporate proxy material. Since these presumably will be part of the annual proxy solicitation, the main new costs imposed will be primarily the cost of lawyer and management time in preparing the proxy disclosure. These costs are not trivial, but given the potentially important corporate governance benefits, such costs would not seem to counsel against using sunset rules, although they may suggest limiting sunset rules to the most significant and suspect of charter provisions.

Finally, what time period should apply for sunset provisions? The answer is somewhat arbitrary, but there is a fairly obvious basic tradeoff. Too short a period will increase the financial costs of sunset rules and force shareholders to vote too often on too many provisions, diffusing their attention. Too long a period will not do enough to deter or eliminate inefficient provisions. Some intermediate time period seems optimal. Offhand, time periods in the five to ten year range would seem to make the most sense, in keeping with the practice described above for sunset rules that currently exist.

Thus, sunset provisions provide another way to make default rules stickier. They force corporations to act periodically, or else the default will re-assert itself. They illustrate the benefit of thinking in terms of degrees of stickiness, rather than default versus mandatory. Sunset provisions do not force the default rule on corporations—they can choose to continue opting out if they want to. However, they do help guard against some of the dangers that can come with overly Teflon rules. They are worth considering as a larger part of the policymaker's toolkit.

171. See Bebchuk et al., *supra* note 166, at 884.

172. See Bebchuk et al., *supra* note 166, at 900.

D. THE DUTY OF LOYALTY

As commonly conceived, probably the most important mandatory rule in corporate law is the duty of loyalty. Although corporations can waive director liability for violations of fiduciary duty through a provision in the charter, they cannot do so for violations of the duty of loyalty.¹⁷³ Those leaning to the mandatory rule side of the great Columbia Symposium mandatory/default debate pointed above all to fiduciary duty rules as the leading example of mandatory rules in corporate law.¹⁷⁴ However, the duty of loyalty can be usefully thought of in a way that makes it into a quite-but-not-infinitely sticky default rule. The underlying default rule is that directors may not enter into a transaction that creates a conflict of interest with the corporation in which a director benefits personally in a way not shared by the corporation.¹⁷⁵ Corporations may opt out of that default rule according to a complicated altering rule procedure.

Once upon a time, the prohibition on conflict of interest transactions was essentially a mandatory rule. Corporations were simply not allowed to enter into conflict of interest transactions with their directors. Over time this mandatory rule eroded. In some circumstances, conflict transactions may be in the best interests of the corporation. Access to inside information and a shared interest in the flourishing of the corporation may make directors willing to enter into a transaction with the corporation on terms more beneficial than those available from any outsider. Strictly forbidding such transactions hurts the corporations which would like to engage in them. Over time, courts recognized this and cut back on the strict mandatory rule.¹⁷⁶

That does not mean that anything goes, though. Conflict transactions clearly present the opportunity for directors to use their power over the corporation to gain personally at its expense. Courts were willing to allow corporations to opt out of the rule prohibiting conflict transactions only where the courts were convinced that doing so was in the best interests of the corporation.¹⁷⁷ Initially, this took the form of requiring directors to show that a specific proposed transaction was fair to the corporation, applying a tough concept of fairness.¹⁷⁸

Nowadays corporations may opt out of the prohibition on conflict transactions in several ways. They may not opt out in advance from the prohibition as applied to any and all conflicts—this is the sense in which the duty of loyalty is a mandatory rule. A corporation may not include a

173. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2007); MODEL BUS. CORP. ACT § 2.02(b)(4) (1979).

174. See Robert C. Clark, *Contracts, Elites, and Tradition in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1705–08 (1989); Coffee, *supra* note 20, at 1619–22; Eisenberg, *supra*, note 19, at 1462; Gordon, *supra*, note 21, at 1593–97.

175. See DEL. CODE ANN. tit. 8, § 144 (2007).

176. See Eric Orlinsky, *Corporate Opportunity Doctrine and Interested Director Transactions: A Framework for Analysis in an Attempt to Restore Predictability*, 24 DEL. J. CORP. L. 451, 455 (1999).

177. *Id.*

178. *Id.*

charter provision specifying that directors will not be held liable for damages resulting from a breach of loyalty. However, a corporation may opt out of the default rule in specific instances through the approval of a majority of disinterested directors, a majority of disinterested shareholders, or if the transaction is fair to the corporation.¹⁷⁹ This is a significantly more sticky altering rule than that prohibiting violations of the duty of care. Corporations can (and most do) opt out in advance from all personal liability for directors for violations of the duty of care through a provision in the charter.¹⁸⁰ In the case of violations of the duty of loyalty, such as conflict transactions, no advance generalized opt-out is possible. The corporation can only opt out in specific instances through appropriate authorization or justification of particular conflict transactions.

Moreover, even opting out of the default prohibition on conflict transactions in a specific instance is not that easy for a corporation to do. As just noted, the corporation must show either approval by informed, disinterested, and independent directors, approval by informed, disinterested, and independent shareholders, or that the transaction was procedurally and substantively fair to the corporation.¹⁸¹ This default rule is thus more or less sticky depending on the stringency of these three tests for removing the taint from a conflict transaction. There is a lot of variance in how strictly courts apply these tests. How much information must be provided to the directors or shareholders approving the transaction? The general answer is all "material" information, but courts may apply the term "material" in a broad or narrow way.¹⁸² Who counts as an "independent" director? In Delaware, the basic test is well-established: Is the director "for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind"?¹⁸³ However, that test is highly fact-specific, and courts may vary in how strictly they apply it.¹⁸⁴ Note that the independence requirement is an allocation of authority as well as a modification of stickiness—it grants approval power to those directors it deems independent. Are the terms of a transaction substantively fair to the corporation? Again, the same words can be applied more or less strictly.¹⁸⁵ Thus, courts can manipulate the degree of stickiness of the altering rule governing a corporation's opting out of the rule banning

179. See DEL. CODE ANN. § 144 (2007); MODEL BUS. CORP. ACT Subchapter F (1979).

180. See DEL. CODE ANN. § 102(b)(7) (2007).

181. DEL. CODE ANN. § 144 (2007); MODEL BUS. CORP. ACT Subchapter F (1979).

182. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 364 (Del. 1993) ("A trial court must have flexibility in determining whether an officer's or director's interest . . . is sufficiently material.").

183. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 920 (Del. Ch. 2003).

184. Compare *Oracle*, 824 A.2d at 937–47 (finding two members of the special litigation committee were not sufficiently independent, where the accused directors were a fellow professor and a large donor to their university), with *Beam v. Stewart*, 845 A.2d 1040, 1050–54 (Del. 2004) (concluding that an allegation of "long standing personal friendship" was insufficient to render a majority of the board interested so as to make demand public).

185. For an argument that courts today apply an overly weak fairness analysis, see Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 426–27 (1993).

conflict transactions based on how they apply the various broad, fact-specific concepts used in the common law definition of fiduciary duty.

So conceived, the duty of loyalty is an example of a tailored altering rule—its application is tailored to specific factual circumstances as understood by a court applying these terms.¹⁸⁶ With tailored altering rules, the degree of stickiness of the rule is essentially a continuum, varying with the way courts apply broad, vague terms to the facts of particular situations. Thus, a descriptive analysis of the stickiness of Delaware corporate law will require a rich survey of how courts have applied fiduciary duties to varying fact patterns.

The evolution and current state of the duty of loyalty is a good example of the practical benefits of having altering rules which allow varying degrees of stickiness. As illustrated, the law's early use of a highly sticky, essentially mandatory rule against conflict transactions was quite likely too harsh, prohibiting many transactions that would have benefited corporations. A strong contractarian would advocate moving to the opposite extreme, making it quite easy for corporations to approve conflict transactions, including approving whole types of transactions in advance through charter, or even bylaw, provisions, as is done for the duty of care. Perhaps that is the correct approach, but there seem to be good reasons for having a rather stickier altering rule than that in the case of conflict transactions. Broad advance opt-outs in the charter are subject to the sorts of objections considered above for charter matters that threaten shareholder interests.¹⁸⁷ Moreover, there is an externality in having courts define fiduciary duties on a case-by-case basis for many corporations. The costs of anticipating all possible eventualities in advance and contracting upon them are prohibitive. Tailored rules such as fiduciary duties allow courts to handle circumstances after the fact, and the accumulation of cases create a body of case law providing rough predictability and guidance.¹⁸⁸ For this to work, there have to be many corporations subject to the fiduciary duty obligations so that courts are able to define the law in many different cases. If corporations were allowed to opt out and too many did, there would be no good case law.

E. INDEPENDENT SIGNIFICANCE AND CONTRACTUAL INTERPRETATION

This sub-part brings together two related complications in analyzing the stickiness of any particular default or altering rule. First, there is often more than one legal means available for achieving a particular goal. A default rule whose altering rule may look quite sticky at first glance may appear much less so when one considers alternative ways of opting out of the default rule. Second, the degree of stickiness of an altering rule will sometimes depend on how courts apply principles of contractual interpretation. In some cases, it will not be entirely clear how to apply

186. See *supra* note 79 and accompanying text.

187. See *supra* notes 175–184 and accompanying text.

188. See Gordon, *supra* note 21, at 1594.

the language that a corporation and/or its shareholders have agreed to. How courts interpret such ambiguous language may determine whether the corporation has succeeded in opting out of a particular default rule, and if so, what alternative it has opted for.

These two issues come together in an interesting line of Delaware cases concerning preference-stripping and preferred shareholders.¹⁸⁹ Preferred shareholders typically have a series of protective rights that they have bargained for, which protect them from future actions by the corporation or later shareholders which may affect their preferences.¹⁹⁰ These rights often give holders of a class of preferred shares the right to vote on certain kinds of actions that will affect their rights.¹⁹¹ The rights are typically written into either the charter or a linked document called the Certificate of Designations.¹⁹² Thus, changing these rights requires amending the charter, and hence one would look to the rules regulating charter amendment to understand the relevant altering rule.

However, one can also accomplish the same thing as a charter amendment via a merger. If the corporation is merged into a shell corporation created for this purpose, and a new charter is written for the surviving corporation, that new charter in effect becomes the amended charter of the old corporation.¹⁹³ To accomplish the change via this route, one would look to the rules regulating corporate mergers. Critically, there are important differences in the rules regulating charter amendments and mergers—the two sets of procedures both protect shareholder, but in different ways. In Delaware, a certificate amendment that affects the rights of an existing class of shareholders must be subject to a class vote, whether or not the existing certificate provides for that.¹⁹⁴ Delaware's merger law does not require such a class vote; however, it does give dissenting shareholders the right to an appraisal, a right not available for dissenters on a vote to amend the certificate.¹⁹⁵

Corporations have with some frequency attempted to circumvent preferred shareholder rights through the merger technique. In a series of cases, the Delaware courts have considered whether such action is valid.¹⁹⁶ The courts have basically answered “yes” by creating and applying the doctrine of independent legal significance.¹⁹⁷ The idea is that two

189. See *Benchmark Capital Partners IV, L.P. v. Vague*, No. Civ. A. 19719, 2002 WL 1732423, at *1 (Del. Ch. July 15, 2002).

190. See DEL. CODE ANN. tit. 8, § 151 (2007).

191. *Id.*

192. D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825, 841 (2004).

193. DEL. CODE ANN. tit. 8, § 251(b) (2007).

194. DEL. CODE ANN. tit. 8, § 242(b)(2) (2007).

195. DEL. CODE ANN. tit. 8, § 262 (2007).

196. See generally Smith, *supra* note 191 (providing a general overview of such methods). Important early cases include *Langfelder v. Universal Laboratories*, 68 F. Supp. 209 (D. Del. 1946), *aff'd*, 163 F.2d 804 (3d Cir. 1947); *Federal United Corp. v. Havender*, 11 A.2d 331 (Del. 1940); and *Warner Communications, Inc. v. Chris-Craft Industries, Inc.*, 583 A.2d 962 (Del. Ch. 1989).

197. *Warner Commc'ns, Inc.*, 583 A.2d at 967–71.

different legal provisions (in these cases the charter amendment and merger provisions) are separate and of equal legal dignity.¹⁹⁸ As long as the corporation satisfies all the legal requirements of a particular provision in attempting to take action by invoking that provision, the action is valid, even if that action sidesteps a certain form of protection that the other legal provision creates and that would have applied had the corporation attempted an action with the same basic effect through use of that other legal provision.¹⁹⁹

In this form, this is essentially a rule of statutory interpretation. In practice, it tends to make default rules easier to opt out of.²⁰⁰ If the corporation can choose two different legal methods to reach essentially the same end, it can choose whichever of the two methods is cheaper and easier to accomplish. Thus, it would seem that the corporate law of Delaware has become less sticky as a result of the doctrine of independent legal significance.

And yet, a funny thing has happened in recent years. As Gordon Smith puts it, the doctrine has morphed from a rule of statutory interpretation to one of contractual interpretation.²⁰¹ Given the existence of the doctrine of independent significance, preferred shareholders who want to protect themselves need to exercise some care in drafting protections that the corporation and later investors will not be able to circumvent. Take as an example the recent case of *Benchmark Capital Partners IV, L.P. v. Vague*, which represents the culmination of this trend.²⁰² Benchmark Capital invested in the A and B rounds of financing for Juniper Financial Corp.²⁰³ They wrote into the certificate several provisions that required approval by A and B investors for a wide variety of corporate actions.²⁰⁴ The main provisions are as follows:

- So long as any shares of Series A Preferred Stock or Series B Preferred Stock remain outstanding, the Corporation shall not, without the vote or written consent by the holders of at least a majority of the then outstanding shares of the Series A Preferred Stock and Series B Preferred Stock, voting together as a single class; provided, however, that the foregoing may be amended, waived or modified pursuant to Section C.4.c: (i) Authorize or issue, or obligate itself to issue, any other equity security (including any security convertible into or exercisable for any equity security) senior to or on a parity with the Series A Preferred Stock or Series B Preferred Stock as to dividend rights or redemption

198. Smith, *supra* note 191, at 832–40.

199. *Id.*

200. The default rules here are the various provisions which define shareholder rights, preferences, and privileges in the absence of specific provisions to the contrary. When they create classes of preferred shares with contractually-agreed-upon features, corporations are choosing to opt out of the default rules for what rights shareholders possess.

201. *Id.* at 840.

202. *Benchmark Capital Partners IV, L.P. v. Vague*, No. Civ. A. 19719, 2002 WL 1732423 (Del. Ch. July 15, 2002).

203. *Id.* at *2.

204. *Id.* at *3–4.

rights, voting rights or liquidation preferences. . . (Section C.6.a(i))

- Series A and B class vote required before Juniper may dispose of all or substantially all of its assets or to “consolidate or merge into any other Corporation (other than a wholly-owned subsidiary Corporation).” (Section C.6.a(ii))
- Series vote required if corporate action would “materially adversely change the rights, preferences and privileges of the Series A Preferred and Series B Preferred Stock.” (Section C.6.c(ii) & C.6.d(ii))²⁰⁵

Juniper’s largest shareholder, Canadian Imperial Bank of Commerce, was given the right to waive these protections, but could not take any action that “would (a) diminish or alter the liquidation preference or other financial or economic rights, modify the registration rights, or increase the obligations, indemnities or liabilities, of the holders of Series A Preferred Stock, Series A Prime Preferred Stock or Series B Preferred Stock or (b) authorize, approve or waive any action so as to violate any fiduciary duties owed by such holders under Delaware law.”²⁰⁶

In any event, Juniper needed more cash, and Canadian Imperial Bank was willing to give it to them in a new financing round, but only if the stock they received had rights senior to the earlier rounds in liquidation preferences, dividends, and redemption rights.²⁰⁷ Juniper accomplished this through a merger into a wholly-owned subsidiary.²⁰⁸ To the uninitiated reader, it might seem that the above provisions rather comprehensively forbid any such action without the approval of the Series A and B shareholders. However, note that none of the quoted language specifically forbids mergers, except for section C.6.a(ii), which exempts mergers into a wholly-owned subsidiary.²⁰⁹ Mergers such as this one would rather clearly seem to fall within the acts prohibited by the other quoted sections, but mergers are not specifically mentioned. As Delaware courts have developed the independent legal significance doctrine, that turns out to be fatal for the Series A and B Preferred Stockholders.²¹⁰ The language they agreed to didn’t contain the magic word—merger—in the right place,²¹¹ and so their attempt to contract around the ability of Juniper to limit their rights failed.

Notice the rather complicated set of default and altering rules we have here. The core default rules are the various portions of corporate law that define what vanilla common shares look like in the absence of corpo-

205. *Id.* at *3–4.

206. *Id.* at *3.

207. *Id.* at *4.

208. *Id.* at *4–5.

209. *Id.* at *3.

210. *Id.* at *7–14.

211. Presumably if section C.6.a(ii), which requires a Series A and B class vote before merger into another corporation, had left out the parenthetical “other than a wholly-owned subsidiary Corporation,” that would have been enough to require a class vote in *Benchmark Capital* even given the approach of the Delaware courts.

ration-specific provisions to the contrary—one share/one vote, no preemptive rights, equal priority in bankruptcy, and so forth. One could imagine a rigid corporate law in which all or many of those rules were mandatory. That is not at all what Delaware looks like—it allows corporations to create shares that differ from the default pattern in a host of ways. Indeed, this is probably one of the areas where corporations do opt out of the default rules most frequently and in the greatest variety of ways. This freedom requires altering rules that specify how corporations may opt out of the default rules. The core altering rule, present in section 151 and adjoining sections of the Delaware code, specifies that a corporation must opt out in the certificate of incorporation, either through a specific provision or through a broad grant of authority to the board to define classes of shares (blank check preferred).²¹²

This core altering rule must be supplemented by an additional element which specifies how a corporation which has already chosen to opt out of the default rules, for example, by creating a class of preferred shares, may make further changes. This is important because, as *Benchmark Capital* illustrates, further changes may hurt the interests of earlier investors. Since the core altering rule requires that opt outs occur in the certificate, it would seem that the altering rule would require that further changes require an amendment to the certificate, following the basic rules for certificate amendment set out in the corporate law.²¹³ However, the basic doctrine of independent significance creates a less sticky altering rule than that: it allows Juniper to change its certificate either through the standard section 242 amendment procedure²¹⁴ or else through a merger, whichever it chooses. However, shareholders may in turn want to change *that* altering rule in order to protect their rights against future investors. The question is, how can they do so? This requires a meta-altering rule, whereby Delaware tells corporations and their shareholders what it takes to alter the base altering rule. The magic word requirement makes that meta-altering rule rather sticky—even if the shareholders have clearly tried to change the altering rule, the courts will not recognize their efforts unless they have used the magic words.

Is there any good justification for this? One could argue that this meta-altering rule is not that sticky. Parties to these sorts of agreements should have good legal counsel, and cases like *Benchmark Capital* should give those lawyers clear guidance as to what it takes to opt out of the base rule. However, as Smith points out, this line of cases has been around for a while now, yet stockholders still seem to be getting it wrong fairly frequently.²¹⁵ Can the rule be justified as a form of stockholder protection?

212. DEL. CODE ANN. tit. 8, § 151 (2007).

213. At least in instances where a corporation has chosen to opt out through specific certificate provisions creating a new class of shares, which is the situation the article is concerned with in this sub-part. Where a corporation has opted out of the default rules for shares through a board's exercise of blank check preferred, the analysis would differ.

214. DEL. CODE ANN. tit. 8, § 242 (2007).

215. Smith, *supra* note 191, at 850.

Perhaps it is intended as a way of protecting common stockholders from preferred stockholders.²¹⁶ It is not, however, clear that preferred stockholders are really such a menace.²¹⁷ The modern use of this rule of contractual interpretation seems to be managers colluding with later preferred investors at the expense of early round investors. It is not at all clear why the protection should go in that direction.

A slightly more plausible explanation might point to a channeling function. The law might want to encourage parties to draft clear, complete contractual language. Doing so may serve an information-forcing function, getting the parties to make their intentions clearer to future courts, and sometimes also inducing one party to reveal information to the other. One way to encourage this is by refusing to recognize language that is not adequately precise. The rule in *Benchmark Capital* does do that.²¹⁸ However, we do not require such extreme precision as a general matter of contractual interpretation, and it is not clear why this situation should require it.

Smith puts forward, though ultimately rejects, another justification for Delaware's approach. He labels the doctrine of independent significance as honoring market solutions, while the alternative he proposes, a more expansive use of the contract notion of good faith, relies more on the courts.²¹⁹ Thus, if one favors markets over courts in this context, that might argue for Delaware's rule. However, I question that characterization. I think it is right to label what Smith calls the statutory interpretation version of the doctrine of independent significance (what I call here the base altering rule) as pro-market. It provides corporations and investors greater flexibility in deciding how to structure their investments and how to alter that structure when new investments occur. However, I am not sure that the pro-market characterization fits what Smith calls the contractual interpretation version of the doctrine (what I call the meta-altering rule). Smith's point seems to be that the sticky meta-altering rule calls for state intervention to enforce the contract less frequently than a less sticky rule would—*Benchmark Capital* is left to fend for itself rather than receiving protection from the Delaware courts.²²⁰ From an ex post perspective, that does indeed seem pro-market. However, from an ex ante perspective it is more problematic. Parties like *Benchmark Capital* and *Juniper Financial* use contracts to help cement the voluntary arrangements into which they have chosen to enter—the essence of market behavior. A standard interpretive method of enforcing those contracts according to the parties' intent as shown by the ordinary meaning of their contractual language would generally seem the best fit to support this

216. *Id.* at 841.

217. William W. Bratton, *Gaming Delaware*, 40 WILLAMETTE L. REV. 853, 858 (2004).

218. *Benchmark Capital Partners IV, L.P. v. Vague*, No. Civ. A. 19719, 2002 WL 1732423, at *7–14 (Del. Ch. July 15, 2002).

219. Smith, *supra* note 191, at 848–49.

220. *Id.*

market-based interaction.²²¹ The sticky *Benchmark Capital* meta-altering rule tends to thwart the intentions of the contracting parties. A less sticky rule would honor the market better.

This odd mix of Teflon altering rule and sticky meta-altering rule seems another manifestation of Delaware's managerialism, which this article has run up against at several points before.²²² Managers can choose to change their ruling document through either section 242 or else a merger, whichever they find easier to do. If shareholders attempt to draft documents to block that ability of managers, though, the courts make it hard for them to draft documents that they will honor. If one strongly believes that markets provide managers with the right incentives and that shareholders' attempt to limit managers will be ill-conceived, this may make sense, but it is not a terribly easy position to defend.

F. ALTERING RULES WITH BROAD SCOPE

Finally, this paper addresses several important types of general altering rules. As discussed in Part III, an altering rule may have a broad or narrow scope. An altering rule is broad insofar as a corporation invoking that rule in one stroke succeeds in altering a number of different default rules, not just one. A general altering rule may be at least to some extent stickier than a specific altering rule that has the same approval requirement, because a general rule involves changing a number of defaults simultaneously. This may create tradeoffs insofar as the corporate actors prefer some of the default rules on one setting of the altering rule but prefer the default rules of the opposite setting on other matters. For instance, in choosing whether to incorporate in Delaware or Minnesota, one might conceivably prefer Delaware's case law on the duty of loyalty but Minnesota's case law on the duty of care and good faith. In that example, it is nearly impossible to mix and match—the corporation must choose either Delaware's law as a whole or Minnesota's.

On the other hand, in other circumstances, the breadth of an altering rule may make it less sticky than the alternative of having to separately opt out of each default covered by the rule. This will be the case where the defaults covered by the broad altering rule complement each other, so that most corporations who would like to opt out of one of the defaults would like to opt out of the others as well. For instance, the provisions covered in Delaware's close corporation statute are all likely to be of use for the same types of corporations. In such cases, a broad altering rule allows corporations to make a number of changes at once, rather than having to alter the defaults one at a time.

221. This is a point Smith recognizes, as seen by his support for the use of good faith to interpret such contracts according to the intent of the parties. *Id.* at 844–48. I am not sure that one needs to resort to good faith here—a simple ordinary meaning approach would seem to get at the intent here without any need to resort to good faith.

222. See *supra* notes 121–25, 135, 151–52 and accompanying text.

In this sub-part, the paper considers several types of altering rules that are broad in this sense, including rules surrounding reincorporation, close corporation rules, federal rules regulating public corporations, and the choice between corporate law and other forms of business associations.

1. *Reincorporation*

One way to change many default rules at once is to reincorporate in another state. How many rules that changes depends on how different the corporate laws of the two states are. An important question is how easy is it, and how easy should it be to reincorporate. Generally, reincorporation is accomplished through a merger, so it is initiated by a majority of the board and, in most states, requires the approval of a majority of voting shares.²²³ Through the internal affairs doctrine, almost every state has agreed that the law of the state in which a corporation is incorporated shall govern the internal affairs of the corporation, including the relationship among directors, officers, and shareholders.²²⁴ This internal affairs doctrine is key to the “genius” of American corporate law, namely the flexibility and responsiveness of state corporate law to the interests of corporations, at least the interests of corporations as perceived by their boards of directors.²²⁵ Of course, there has been much debate over whether this system has led to a race to the top or a race to the bottom in state corporate law.²²⁶ Those who embrace the system are generally contractarians who embrace a Teflon default approach to corporate law overall. Those supporting tougher regulation are typically more skeptical about the results of the internal affairs doctrine.²²⁷

Should reincorporation be easier to accomplish? Some have suggested allowing shareholders to reincorporate on their own.²²⁸ This is a rather nifty contractarian response to a problem from people skeptical about contractualism and state competition in corporate lawmaking. The concern with state competition is that since boards and officers typically control the decision as to where to incorporate, state law winds up favoring managers over shareholders too much.²²⁹ If one were to allow sharehold-

223. See *supra* notes 147–48 and accompanying text on merger approval requirements.

224. See Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 35–36 (2006). A few deviate somewhat from the internal affairs doctrine, most notably California. See CAL. CORP. CODE § 2115 (West 2007).

225. See generally ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

226. For my take on this question, see generally Brett H. McDonnell, *Delaware, Federalism, and the Expertise-Bias Tradeoff*, 2004 Law and Economics Workshop, University of California-Berkeley, http://repositories.cdlib.org/berkeley_law_econ/Fall2004/6/; Brett H. McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. CORP. L. 99 (2004); Brett H. McDonnell, *Recent Skirmishes in the Battle Over Corporate Voting and Governance* (Minnesota Legal Studies Research Paper No. 07-04), available at <http://ssrn.com/abstract=960278>.

227. See Robert Ahdieh, *Dialectical Regulation*, 38 CONN. L. REV. 863, 863 (2006).

228. Bebchuk, *supra* note 132, at 868–69.

229. See *id.*; see also William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663, 698 (1974).

ers to initiate reincorporation on their own and to accomplish it without board approval, the balance of power would shift. State rulemakers would then presumably have more incentive to look out for the interests of shareholders, since they would be the ones with the most influence over where companies incorporate.

This possibility shows a flaw in Bernard Black's argument that the ease of reincorporation makes many state law rules easily avoidable, and hence trivial.²³⁰ The fact that corporations cannot reincorporate without board approval tends to make state law more pro-manager than it would be if shareholders could reincorporate without board approval. By the same token, the law would presumably become even more strongly pro-management if boards could reincorporate without shareholder approval. Thus, again it is not simply the ease in terms of monetary costs of altering rules that matters, but also how they distribute authority.

There is of course much debate over whether this proposal actually addresses any real problem. I will not take up that question here—in other work, I have taken an intermediate position, suggesting that Delaware corporate law does tend to be flexible and efficient, but it also tends to be overly pro-management.²³¹ Thus, I do agree in part with those who think there is a problem. Even if there is, however, this solution could conceivably create more problems than it solves. Shareholders may not be as good as management at discerning which state's rules are best for a given corporation, although I am skeptical of that point. More seriously, reincorporating in a new state may involve re-considering all of a corporation's charter and bylaw provisions, and figuring out how these should be changed to conform and adapt to the laws of the new state. Shareholders may not do that as well as managers. Finally, the kinds of arguments that Bainbridge gives for board primacy²³² may apply to this question, although the exact application of that argument to this question is not clear.

Should reincorporation be harder to accomplish? An intrepid minority of American scholars suggests doing away with the internal affairs doctrine, in favor of requiring a corporation to follow the law of the state in which it does business.²³³ This makes the reincorporation altering rule quite sticky indeed—choosing to move and do business elsewhere is quite a drastic and costly response to unhappiness with a state's corporate law.

A few states already do not fully follow the internal affairs doctrine. California is the most significant example. Corporations incorporated elsewhere that have a strong enough tie to California in terms of sales and shareholders are required to follow California law on a variety of

230. See Black, *supra* note 33, at 558.

231. See articles cited *supra* note 226.

232. See *supra* notes 122–23 and accompanying text.

233. Kent Greenfield, *Democracy and the Dominance of Delaware in Corporate Law*, 67 LAW & CONTEMP. PROBS. 135, 145 (2004); Daniel J.H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 YALE L. & POL'Y REV. 381, 454 (2005).

points.²³⁴ However, this rule is sharply limited by the fact that it does not apply to corporations whose shares are traded on the New York Stock Exchange or Nasdaq.²³⁵

Why might one want to limit or completely abolish the internal affairs doctrine? Presumably, this would require a strongly anti-contractarian theory for support. One might oppose the internal affairs doctrine on shareholder protection grounds if one believed quite strongly in the race-to-the-bottom theory. Another ground for opposing the internal affairs doctrine would point to the effect of corporations and corporate law on other constituencies, such as employees and local communities. It is quite plausible that due to charter competition, state corporate laws do not take such constituencies into account. The traditional response is that other, non-corporate laws should be used to protect such constituencies. Maybe so, but one might believe that structuring decisionmaking within the corporation, as corporate law does, might be a better way of protecting such constituencies. Further exploration along these lines would take this paper from its main theme though.²³⁶ Note that in seeing reincorporation as an altering rule, this paper has illustrated the same basic logic that is seen elsewhere—those who believe that market forces tend to lead corporations to good choices advocate a non-sticky rule, while those skeptical of the market generally argue for more stickiness. However, one also notices an ambiguity: sometimes those favoring more shareholder protection advocate making the rule *less* sticky, by taking the board out of the process and letting shareholders act on their own.²³⁷

2. *Close Corporations*

Some states have special rules for close corporations. If a corporation meeting requirements concerning number of shareholders and so on elects to be a close corporation, a variety of special rules may apply to it. By choosing close corporation status, a company opts out of some important standard default rules and opts into a new set of rules. Thus, the rules for electing into, and out of, close corporation status form a somewhat broad altering rule. This is also an example of a menu—by choosing to be a close corporation, a company buys into an interrelated set of rules that lawmakers believe form a useful whole for certain types of corporations with a small number of shareholders. In analyzing this type of altering rule, one should consider both how broad the rule is—for instance, how many governing rules are changed by close corporation status—and also how sticky the close corporation altering rule is.

234. CAL. CORP. CODE § 2115 (West 2007).

235. *Id.* § 2115(c). California is not, however, the only state that does not fully follow the internal affairs doctrine for some specific points of law. For example, in the notable case of *Sadler v. NCR Corp.*, New York state law concerning shareholder list disclosure rule was applied to a Maryland corporation. 928 F.2d 48, 53–56 (2d Cir. 1991). For a list of other instances, see Greenwood, *supra* note 233, at 423–24.

236. For a discussion of related arguments, see McDonnell, *supra* note 62.

237. The paper addressed this ambiguity in its discussion of shareholder bylaws.

Consider Delaware's close corporation rules as an influential example.²³⁸ This paper first examines the stickiness of close corporation statutes in Delaware. A company must satisfy several requirements in order to qualify as a close corporation:

- It cannot have more than thirty shareholders;²³⁹
- All outstanding shares must be subject to at least one transfer restriction;²⁴⁰
- The corporation may not engage in a public offering, as defined in the Securities Act of 1933;²⁴¹ and
- It must contain a provision in its certificate of incorporation stating that it elects to be a close corporation, with at least two-thirds of the outstanding shares of each class of stock approving this provision.²⁴²

Thus, it is not easy for a corporation to become a close corporation. For most corporations with significantly more than thirty shareholders, the gains from close corporation status will not justify the costs of buying out existing shareholders to reduce down to the thirty level,²⁴³ and even corporations with fewer than thirty shareholders may value the flexibility of being able to attract more shareholders, and hence find this limitation too constricting. Many corporations may also find the share transfer restriction requirement burdensome because it limits shareholder liquidity, although many corporations that find close corporation status attractive may find various transfer restrictions independently attractive. The public offering restriction probably adds little to the stockholder number restrictions, as most public offerings will result in companies with more than thirty stockholders. The two-thirds supermajority restriction also makes this altering rule more sticky than the standard majority provision that is seen in most contemporary corporate law altering rules,²⁴⁴ as does the fact that the provision must be in the certificate, not the bylaws.²⁴⁵ Thus, as a result of these various measures, the close corporation altering rule is rather sticky, although for the types of corporations that are likely to find close corporation status desirable, these restrictions may not be very onerous. Close corporation statutes in some other states have different rules for becoming such a corporation, but they are broadly similar.

Also relevant to the stickiness of the close corporation altering rule is how easy it is to opt out of close corporation status once a corporation has opted in. There are two basic ways for a close corporation to choose to cease being such. First, the corporation may remove the charter provi-

238. Delaware's close corporation rules are contained in subchapter XIV of the Delaware General Corporation Law, sections 341–56. DEL. CODE ANN. tit. 8, §§ 341–56 (2007).

239. DEL. CODE ANN. tit. 8, § 342(a)(1) (2007).

240. DEL. CODE ANN. tit. 8, § 342(a)(2) (2007).

241. DEL. CODE ANN. tit. 8, § 342(a)(3) (2007).

242. DEL. CODE ANN. tit. 8, § 344 (2007).

243. There is, however, some room to manipulate the number of shareholders of record.

244. See *supra* Part IV.B.

245. See *supra* Part IV.A.

sion electing to be a close corporation.²⁴⁶ This route requires the same supermajority approval required for enacting the provision in the first place; namely, it must be approved by at least two-thirds of the outstanding shares of each class of stock.²⁴⁷

The other way to opt out of close corporation status is to breach the stockholder number, transfer restriction, or public offering restrictions and not take corrective action.²⁴⁸ This is rather easy to do in most corporations. Because the board has the power to issue new shares, the board on its own, (absent charter, bylaw, or shareholder agreement provisions limiting this board power), may issue shares to new stockholders that put the total number of stockholders over thirty, or may issue new shares without any transfer restrictions. Indeed, the board could do this inadvertently, particularly in the case of the thirty stockholder limit. Moreover, it need not take any board action to exceed the stockholder limit—the transfer of shares from one stockholder to many, through sale or death, could push the number over thirty.

The other question concerns how broad the close corporation statute is. What different rules apply to close corporations? Delaware has six main special provisions for close corporations.

- Written agreements signed by a majority of stockholders will not be held invalid on the ground that they restrict the discretion of the board.²⁴⁹ I have never quite understood the need for this provision, given that stockholders can always limit the discretion of the board in the certificate.²⁵⁰ Of course, a stockholder agreement does not require board approval, while amending the certificate does. Becoming a close corporation in the first place does require board approval, however, because it requires a certificate provision. Nonetheless, once a corporation has become a close corporation, stockholders can then act to limit the board without board approval, which increases their power somewhat.
- Stockholders may manage the corporation without a board, if the certificate so provides.²⁵¹
- The Chancery Court may appoint a custodian for a close corporation if it is deadlocked.²⁵²
- The Chancery Court may appoint a provisional director for a close corporation if it is deadlocked.²⁵³
- No stockholder agreement may be held invalid on the ground that it is an attempt to treat the corporation as if it were a

246. DEL. CODE ANN. tit. 8, § 346(a) (2007).

247. *Id.* The certificate may increase, but not decrease, this supermajority required for opting back out of close corporation status. DEL. CODE ANN. tit. 8, § 346(b) (2007).

248. DEL. CODE ANN. tit. 8, § 345(b) (2007). The corrective action that can resolve a breach of one of the conditions is laid out in DEL. CODE ANN. tit. 8, § 348 (2007).

249. DEL. CODE ANN. tit. 8, § 350 (2007).

250. DEL. CODE ANN. tit. 8, § 141(a) (2007).

251. DEL. CODE ANN. tit. 8, § 351 (2007).

252. DEL. CODE ANN. tit. 8, § 352 (2007).

253. DEL. CODE ANN. tit. 8, § 353 (2007).

partnership.²⁵⁴

- The certificate may contain a provision allowing a specified number of stockholders to dissolve the corporation.²⁵⁵

The first rule (stockholder agreement limiting board discretion), second rule (managing without board), and fifth rule (stockholder agreement treating corporation like a partnership) are aimed at the general grant of broad power to the board, a grant which this paper has shown at several points that the law makes hard to alter. Once a company has chosen to be a close corporation—not easy in itself—it becomes somewhat easier to limit board power or even to do away with the board altogether. In companies with a small enough number of stockholders, the law treats the presumption favoring board control as weaker, presumably because in such companies, stockholder involvement in management is more feasible; indeed, in many such companies, the stockholders, directors, and officers are all the same people.

The other close corporation rules relate to the appointment of custodians or provisional directors in the case of deadlock and concerning stockholders dissolving the corporation. These rules aim at a different issue confronting companies with a small number of stockholders who actively manage the business. With a small number of people both owning and running the business, the chance of an irresolvable conflict within that small group becomes a large potential problem. These rules give stockholders and the courts tools to help resolve such conflicts.

Thus, the rules for becoming a close corporation under the Delaware statute are not an incredibly broad altering rule. Opting out of the usual rules and into the close corporation rules does not change most of the default rules for a Delaware corporation. However, it does make fairly significant changes along two important dimensions; namely, the ability to limit board power and the options available for dealing with deadlock. The altering rule only allows corporations with a small number of stockholders to exercise the option to choose these rules. It is quite clear why these rules are much more useful to corporations with just a few stockholders, although perhaps not completely clear why the rules should not also be available to larger companies that would like to be governed by them.

There is another lesson here of general relevance to this paper's project. This somewhat broad altering rule provides a new menu option to Delaware corporations. For corporations with just a few stockholders, more direct stockholder control and provisions for dealing with deadlock are likely to be quite helpful. Rather than having to devise relevant rules piecemeal, the close corporation statute allows companies to opt in to a somewhat different structure than the general corporate law. Thus, this is a case where the breadth of the altering rule may make it less sticky rather than more sticky—since the defaults grouped together are comple-

254. DEL. CODE ANN. tit. 8, § 354 (2007).

255. DEL. CODE ANN. tit. 8, § 355 (2007).

mentary, most corporations choosing to opt in will probably find all of the close corporation provisions attractive, and it will lower their costs to be able to opt in to all at once rather than having to adapt piecemeal.

3. *Public Corporations*

This paper now addresses another important altering rule with broad scope as it turns from state corporate law to the closely related area of federal securities law. Many important securities law rules apply only to reporting companies. Reporting companies are required to file periodic reports under the Exchange Act;²⁵⁶ they must comply with the SEC's proxy solicitation rules;²⁵⁷ their officers and directors must disclose purchases and sales of company securities;²⁵⁸ and they are subject to the myriad regulations of the Sarbanes-Oxley Act.²⁵⁹ These rules impose significant costs on the companies subject to them. They may also create significant benefits for their stockholders and for the markets for their securities. Whether or not the costs typically outweigh the benefits is of course one of the hotly-debated topics of securities law scholarship.

The rules defining a reporting company thus clearly have a broad scope—in becoming a reporting company, an issuer in one fell swoop becomes subject to many new rules to which it was not previously subject. How sticky is this altering rule? That is, how easy is it for a corporation to choose to become a reporting company, or to choose to cease being a reporting company?

A company becomes a reporting company in one of three ways:

- Its securities are listed for trading on a national securities exchange,²⁶⁰ including, most importantly, the New York Stock Exchange and Nasdaq;
- The company has over five hundred shareholders of record and assets exceeding \$1 million;²⁶¹
- The company has had a registration statement become effective under the Securities Act of 1933.²⁶²

How easy is it for a company to choose whether or not to be a reporting company under any of these rules? Under the first rule, the company's board can always choose not to list on a national exchange, or to de-list if it is currently listed. However, there are significant benefits associated with the liquidity that comes with listed shares, so choosing not to list one's shares in order to avoid the consequent regulations that will

256. Securities Exchange Act of 1934 §§ 13(a), 15(d), 15 U.S.C. §§ 78m(a), 78o(d) (2006).

257. Securities Exchange Act of 1934 § 14(a), 15 U.S.C. § 78n(a) (2002).

258. Securities Exchange Act of 1934 § 16(a), 15 U.S.C. § 78p(a) (2007).

259. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204(2)(a)(7), 116 Stat. 743 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

260. Securities Exchange Act of 1934 § 12(a), 15 U.S.C. § 78e(a) (2004).

261. Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78l(g) (2004); 17 C.F.R. § 240.12g-1 (2007).

262. Securities Exchange Act of 1934 § 15(d), 15 U.S.C. § 78o(d) (2006).

follow carries a sizeable price tag. In the other direction, not every corporation can choose to list on an exchange. The national exchanges have relatively stringent listing standards.²⁶³ Companies with stockholders, assets, or revenues that fall below the standards cannot become reporting companies via this route. Companies must also pay fees.

As for the second route to becoming a listed corporation, in most instances, it will not be very easy for a corporation to manipulate its assets or number of stockholders in order to either become a reporting company or avoid becoming a reporting company, as the case may be.²⁶⁴ The number of stockholders of record is subject to some manipulation. However, that manipulation is not infinite. Companies with a large number of stockholders will not be able to merely manipulate their reported figure. To fall below the required threshold, they will need to buy out many stockholders, which is often quite expensive and has many collateral consequences that the corporation often finds unpleasant. Similarly, for corporations that fall either well below or well above the \$1 million asset figure, there will be little they can feasibly do to become, or avoid becoming, a reporting company.

As for the third and final route, registering securities with the SEC is relatively expensive—not many companies will want to do so simply to enjoy the pleasures of being a listed company. In the opposite direction, corporations may certainly choose not to engage in a registered offering, and thereby avoid becoming listed if they do not fall under either of the other two conditions; however, doing so may have costs. If the company wants to raise capital by issuing securities, but not registering them, it must fit its offering under one of the exemptions to the registration requirement of the Securities Act.²⁶⁵ Doing so may impose significant limitations on how it may structure its offer, and to whom it may sell its securities.

Thus, for most corporations it will not be easy to deliberately choose whether or not to be subject to the various rules that apply to a reporting company. It is possible to choose to avoid these rules. Indeed, in the wake of the increased costs associated with Sarbanes-Oxley, a variety of companies appear to have chosen to go private or to delay going public.²⁶⁶ However, doing so is costly—one must forego the benefits of being on a national exchange, and one must limit the number of stockholders one has. For large companies with a wide stockholder base, this will be

263. NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL §§ 102.01–.05 (2007), available at <http://www.nyse.com/regulation/listed/1147474807344.html>; NASDAQ MANUAL § 4310 (2007), available at <http://www.nasdaq.complinet.com/nasdaq/display/index.html>.

264. The move from reporting to not reporting is made harder by the fact that the company must drop to under 300 shareholders. See Securities Exchange Act of 1934 § 12(g)(4), 15 U.S.C. § 78l(g)(4) (2007); 17 C.F.R. § 240.12g–1 (2007).

265. See Securities Act of 1933 §§ 3–5, 15 U.S.C. §§ 77(c)–(e) (2004).

266. See Ehud Kamar et. al., *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis* (USC Legal Studies Research Paper No. 06–10), available at <http://www.ssrn.com/abstract=901769>.

prohibitively expensive. Note that this suggests a somewhat different, though complementary, explanation for the fact that it was generally small public corporations that chose to go private after Sarbanes-Oxley. The standard explanation is that the costs associated with the Act were proportionately higher for small businesses, given the high fixed costs of parts of the Act.²⁶⁷ That is presumably right, but another part of the story may be that it is easier for small corporations to go private than for large ones, given the relevant altering rule.

Does this sticky altering rule make sense? Strong contractarians would let corporations choose what securities laws govern them.²⁶⁸ They would presumably not like this altering rule. The contrast with the Teflon altering rule of the internal affairs doctrine is striking. If anything justifies the sticky altering rule here, it is presumably a shareholder protection rationale, combined with a market imperfection story. This question largely tracks the longstanding and voluminous debate over the efficacy of mandatory disclosure rules,²⁶⁹ and the more recent but increasingly voluminous debate over the efficacy of Sarbanes-Oxley.²⁷⁰

Thus, the securities law definition is one area of corporate and related law where the altering rule is pretty sticky. This is in keeping with the more regulatory character of federal securities law as compared with state corporate law. The altering rule perspective focuses one's attention on the rules defining when a company will or will not be covered by a part of the securities law regime, and how easy it is for companies to avoid that regulation. As discussed, this suggests a somewhat different explanation for why mostly small companies have chosen to go private after Sarbanes-Oxley. It suggests that greater attention might fruitfully be paid to how easily companies can manipulate the rules described above. Normatively, the altering rule perspective fits in naturally with the growing debate over issuer choice in securities law.²⁷¹

4. Unincorporated Business Associations

An organization can always choose to be treated as something other than a corporation—a partnership, a limited liability company, and so on. A business that chooses to be a corporation will be governed by one set of default rules, while a business that chooses to be a LLC will be gov-

267. *Id.* at 1–3.

268. Advocates of issuer choice include Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998), and Stephen J. Choi & Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL L. REV. 903 (1998). For a critique of issuer choice, see Fox, *supra* note 101, at 1337–38.

269. See *supra* note 101 and accompanying text.

270. See, e.g., Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 917–23 (2003); Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817, 1817–20 (2007); Brett H. McDonnell, *SOx Appeals*, 2004 MICH. ST. L. REV. 505, 505–09; Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005).

271. See *supra* note 268 and accompanying text.

erned by a quite different set of default rules. The availability of a variety of different organizational forms means that organizers of a new business are presented with a menu.²⁷² Those choosing from this menu face major tradeoffs—being a corporation will be more attractive in some ways and less so in others. A variety of questions arise here within our framework: how easily should the law allow businesses to choose which defaults apply to them in the first place, and how easily should it allow them to change that choice once they have done so?

The choice of a particular entity form is generally pretty easy. Organizers must file some documents with the relevant Secretary of State whose filing requirements are not terribly onerous.²⁷³ Traditionally, there were not many entity types available from which to choose. Most starkly, going back many decades, the choice was essentially between a partnership or a corporation. Many different default rules applied to the two, so the choice between them was a very broad altering rule indeed. Limiting the menu to the two options made the choice more difficult and costly, insofar as the organizers preferred some of the rules governing corporations and other rules governing partnerships. That cost is reduced to the extent that the various default rules that apply to a corporation can be modified on a rule-by-rule basis. Organizers can then choose the basic form that best suits them and then opt out of the various defaults in the form they have chosen that do not suit them. Modern corporate law, as addressed here, does indeed provide much flexibility of that sort. Many individual rules, however, are at least moderately sticky, such that opting out of them is moderately costly. Moreover, the sheer number of rules an organization may want to modify, if it prefers a structure somewhere in the middle between a corporation and a partnership, would itself impose significant costs to adjusting on a rule-by-rule basis.

Hence, the proliferation of hybrid entity forms is a significant step in a contractarian direction. The menu facing business organizers today includes a variety of legal forms that mix and match the characteristics of corporations and partnerships: limited partnerships, limited liability partnerships, limited liability limited partnerships, limited liability companies, business trusts, and so on. It is now possible for the initial organizers of a business to choose a basic legal form that comes closer to their desired structure, such that they will need to do less rule-by-rule modification. As noted earlier, this is a leading example of how the introduction of statutory menus decreases the costs of choosing to opt out of or into various default rules.²⁷⁴ The advantages in reducing transaction costs for organizers and investors are obvious. Insofar as there is a decent argument against this proliferation of legal entities, it involves the protection of in-

272. See Ayres, *supra* note 6, at 3; Listokin, *supra* note 58, at 1–2.

273. See DEL. CODE ANN. tit. 8, §§ 101, 103 (2007); MODEL BUS. CORP. ACT §§ 2.01, 2.02, 2.03 (1979).

274. See *supra* notes 87–88 and accompanying text.

voluntary creditors who may be hurt by the increased ease of obtaining limited liability status.

Opting out of a particular legal form of association once it has been chosen is more costly, but is far from being prohibitively so. Basically, a corporation may merge into an unincorporated entity, or vice versa, following the rules for approval of a standard merger.²⁷⁵ This paper has already discussed mergers, and found that they are not Teflon in their ease, but they are not highly sticky either.²⁷⁶ This is somewhat striking—it means that even a major change in organizational form, resulting in changes in applicable legal rules and protections, can be imposed on a minority of investors without their approval. However, for those companies moving from a corporate form, the appraisal remedy provides some protection,²⁷⁷ while for those moving to the corporate form from unincorporated entities, the dissolution rules will typically provide significant protection.²⁷⁸ Put very broadly, both sets of rules will allow judicial intervention to determine that investors who do not want to continue in the new entity will get fair compensation for their investment. Of course, how well those procedural protections work is a tough, complicated question—luckily, one that is beyond the scope of this paper.

The rules for choosing organizational form are among the very broadest of all altering rules. Many varying default rules come with this basic choice. As noted previously, packaging together so many default rules chosen through one altering rule can either create much stickiness or greatly facilitate choices, depending on how well the various defaults covered by the altering rule hang together. If many companies are likely to approve of some of the defaults but not others, they will find it costly to change organizational form because doing so will involve hard trade-offs. If instead most companies find that one of the alternative legal forms on the menu tends to bundle together defaults that fit its needs well, then the breadth of this altering rule will reduce transaction costs. Insofar as American business organization law in recent years has succeeded in creating a variety of alternative organizational forms, each of which offers a bundle of rules that is likely to appeal to many businesses, the law has thereby chosen a significantly less sticky path.

V. CONCLUSION

In the previous part, this article went on a whirlwind tour through a variety of topics in corporate law. For each of these topics there is, of course, very much more to say. The point has not been to exhaustively explore any single area of the law. Rather, I hope to have illustrated

275. DEL. CODE ANN. tit. 8, §§ 263(c), 264(c) (2007); MODEL BUS. CORP. ACT §§ 11.02, 1.40(7B) (1979).

276. See *supra* notes 139–141 and accompanying text.

277. See DEL. CODE ANN. tit. 8, § 262 (2007); MODEL BUS. CORP. ACT Ch. 13 (1979).

278. See REV. UNIFORM P'SHIP ACT art. 6–8 (1997).

several points concerning the concept of altering rules as applied to corporate law.

Descriptively, the altering rule concept focuses one's attention on some questions corporate law scholars have left under-explored. How easy does the law make it for corporations to opt out of the default rules that their jurisdiction has established? Who gets a say in deciding whether and how to opt out of the prevailing rule? Does the law take a tailored or untailored approach to deciding whether or not to recognize an attempt to change the default? Do particular actions work to change just one default rule or many defaults at once? To what extent, and how, can corporations change the procedure that applies to their own future efforts to change the rules that apply to them? Of course, scholars have asked variants of these questions before. However, they have not been a central focus of scholarly attention. These questions shine a light on many notable features of corporate law: bylaws versus charters, supermajority rules, sunset provisions, merger law, fiduciary duty, the doctrine of independent significance, reincorporation and the internal affairs rule, close corporation rules, securities law rules affecting public corporations, and choice of legal entity, among other topics. Thus, the altering rule concept also can help integrate one's thinking about corporate law.

This discussion has also cast some doubt on one leg of Black's triviality hypothesis, namely the notion that most corporate law rules are avoidable at low cost.²⁷⁹ Viewed over a long enough time horizon, Black is probably right—over the course of decades, corporations within the markets can and will opt out of rules they do not like through charter amendments, charter provisions in IPOs, reincorporation, and so on. But in the long run we are all dead. Within time-spans of real interest, the costs of change for many rules are high enough that they are not trivial. They are not prohibitive, but not trivial either.²⁸⁰

Normatively, the concept of altering rules, and their stickiness, highlights the fact that lawmakers have a more varied and nuanced set of policy tools at their command than the simple default/mandatory rule distinction suggests. Contractarianism has made a strong case against mandatory rules in corporate law. The same set of rules will not be best for every corporation; the rulemakers may not hit on the best set of rules; markets will put severe pressures on attempts to mandate behavior that market actors do not want mandated. However, the anti-contractarians have some strong counter-points. Market constraints on opportunism by managers against shareholders have many weaknesses. Constituents other than shareholders may need protection as well. A purely Teflon set

279. See Black, *supra* note 33, at 555–59.

280. That does not address the three other reasons Black gives for triviality. Those lie beyond the scope of this paper, although to some extent my articles on corporate law federalism address elements of Black's arguments concerning market mimicking rules and political changeability. See *supra* note 226.

of default rules would face serious criticism from the anti-contractarian position.

The availability of altering rules of varying levels of stickiness allows lawmakers to strike various possible tradeoffs between the problems posed by the extremes of Teflon defaults and mandatory rules. In many, though not all, cases, an intermediate degree of stickiness will lead to a better outcome than would either of the extremes. Thus, the normative analysis complements the descriptive analysis. The descriptive analysis suggests that the law's altering rules often choose an intermediate degree of stickiness, and the normative analysis suggests that the law is probably sensible in doing so. It is already sensible, but a conscious focus on these aspects of corporate law will help us design reforms that can improve that law.

Now that this paper has reached the end, I shall cop to a deliberately-maintained ambiguity in this paper's normative analysis. At various points along the way, the paper has run up against features in existing law that I found somewhat hard to justify normatively. That is particularly the case for various parts of the law where the altering rules make it difficult to opt out of the law's broad grant of authority to the board.²⁸¹ At these points, I have evaded close examination of the question whether existing corporate law is in fact optimal. Answering that question is not easy, to say the least. It requires a strong theory about what the law is trying to accomplish, clear empirical evidence on how the law actually works in practice, and probably also answers to the long-debated controversy over the race to the bottom in setting corporate law. For this paper's purposes, though, I do not need to answer those questions. I merely want to show the usefulness of the altering rule concept in analyzing the issues. If one believes that state corporate law strongly tends toward efficiency, then observation of the existing altering rules should tell one what outcome one needs to justify. If one believes that the law instead tends to inefficiently prioritize the interests of managers, then the altering rule framework helps one think about what alternative rules would be better.²⁸²

Despite this ambiguity, an overall picture emerges that differs notably from the picture painted by a strong version of the contractarianism that dominates corporate law scholarship. The law guides the corporate contract more pointedly than simple contractarianism would suggest, and the law seems to be acting quite sensibly in doing so. Yet, the picture is not strongly anti-contractarian either. The arguments of the contractarians should be given their due, but no more than their due.

281. See *supra* notes 122–23, 151–63, and 222, and accompanying text. As I note in those parts of the text, the director primacy theory of Stephen Bainbridge comes closest to providing a satisfactory account of this pervasive feature of corporate law. For reasons beyond the scope of this article, I ultimately do not agree with Bainbridge's normative account.

282. My position on the race to the bottom debate is somewhere in between the extremes. See articles cited *supra* note 226.

Note that the idea of altering rules is of interest well beyond the sphere of corporate law. Its birthplace is contract law, where the paper by Ayres and Gertner²⁸³ is the most extensive discussion to date (of which I am aware). Part IV.D on the doctrine of independent significance and contract interpretation gives a brief sense of the use of the altering rule concept in the contracts context. It can be used elsewhere. For instance, the idea of different types of default rules has been applied to statutory interpretation, and the notion of altering rules should help there as well. Clear statement rules, for instance, are a type of sticky altering rule. Another example of an application of the altering rule concept is that of labor law, where the recent debate over the secret ballot in union elections focuses one's attention on the rules that govern how businesses opt in to unionization, and hence to the coverage of the laws governing the relationship between unions and employers. Wherever the distinction between default and mandatory rules has proved useful, the idea of altering rules should help push scholarly discussion further.

283. *Supra* note 43.

Table 1

Provisions that May Be in <i>Either</i> the Certificate <i>Or</i> the Bylaws	
Del. Gen. Corp. L. sect.	Provision
109(b)	Provisions relating to business of the corporation, conduct of its affairs, and rights or powers of stockholders, directors, officers, or employees
110	Board may enact emergency bylaws containing any provision practical and necessary for an emergency due to attack
141(b)	Fix size of the board
141(b)	Require that directors be stockholders
141(b)	Vary board quorum
141(b)	Vary board majority required for action
141(c)	Delegate board powers to committee
141(c)	Give committee power to appoint directors to act at a committee meeting
141(c)	Limit power of committee to create subcommittees
141(d)	Create staggered board (initial bylaw or shareholder-adopted bylaw only)
141(f)	Restrict ability of board to act without a meeting
141(g)	Restrict ability of board to meet outside Delaware
141(h)	Restrict ability of board to fix compensation of directors
141(i)	Restrict ability of directors to participate in meetings by phone or similar method
142(a)	Define powers of officers
142(a)	Restrict ability of persons to hold more than one office
142(b)	Provide for manner of choosing officers
142(e)	Provide for manner of filling officer vacancies
202(b)	Impose restrictions on transfer of shares
203(b)	Opt out of section 203 business combination rule
211(a)(1)	Designate place for stockholder meetings
211(b)	Set manner for setting time for stockholder meetings
211(e)	Authorize persons to call special stockholder meetings
216	Specify quorum for stockholder meetings
222(c)	Require notice for adjourned meetings
223(a)	Limit ability of board to fill board vacancies
223(d)	Limit ability of board to fill vacancies where one or more director has resigned
231(e)	Extend section's provisions on inspectors of elections to corporations not listed on national securities exchange or nasdaq

Provisions that May Be <i>Only</i> in the Certificate	
Del. Gen. Corp. L. sect.	Provision
102(a)	Certificate sets forth name, address, nature of business, number of authorized shares, name and address of incorporator, initial directors
102(b)(3)	Preemptive rights
102(b)(5)	Limit to duration of corporation's existence
102(b)(6)	Personal liability for debts imposed on stockholders or members to a specified extent
102(b)(7)	Limit on personal liability of directors for violations of fiduciary duty
109(a)	Confer upon the board the power to amend bylaws
121	May grant powers and privileges necessary and convenient to conduct of business
122(17)	Renounce interest of the corporation in specified business opportunities or classes of opportunities (may also be done by action of the board)
141(a)	Restrict power of board to manage business and affairs
141(d)	Give class of shareholders right to elect director(s)
141(d)	Give one or more director more or less voting powers than other directors
141(k)(i)	Allow removal of directors without cause in classified board
151(a)	Specify rights and powers of classes of shares
151(c)	Specify dividend rights of preferred shareholders
151(d)	Specify other rights of preferred shareholders
151(e)	Specify convertibility of classes of shares
153(a), (b)	Give stockholders power to determine consideration for shares
153(c)	Give stockholders power to determine how to dispose of treasury shares
153(d)	May require supermajority for stockholder votes determining share consideration
157(a)	Limit ability to issue rights and options respecting stock
157(b)	Set terms upon which shares may be acquired upon exercise of rights or options
170(a)	Restrict ability of board to pay dividends
170(b)	Restrict ability of board to determine net profits of corporation engaged in exploitation of wasting assets
211(b)	Limit ability of stockholders to elect directors by written consent
212(a)	Vary from one share/one vote rule
214	Allow cumulative voting
221	Give bondholders the right to vote on corporate affairs
228(a)	Limit ability of stockholders to act by written consent
251(f)	Require stockholder vote in circumstances where not required by the sub-section

251(g)	Require stockholder vote in circumstances where not required by the sub-section
273(a)	Prevent shareholders in joint venture corporation from petitioning court to discontinue venture (may also be done in shareholder agreement)
342(a)	Elect to be a close corporation
342(b)	Set stockholder qualifications in a close corporation
346	Elect to cease being a close corporation
351	Provide that stockholders in a close corporation may manage the business
355(a)	Provide that stockholder may have close corporation dissolved at will upon occurrence of specified contingency

